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Accounting News And Trends

A Loss to the Profession

The entire accounting profession suffered a serious loss with the sudden death of Robert L. Kane, Jr. on December 31, 1957. Bob Kane was Director of Education of the AICPA and, among other activities, was responsible for coordinating the preparation and grading of the CPA examinations. Prominent amongst his professional contributions was the editing of the two-volume *CPA Handbook* and his serving as secretary of the Commission on Standards of Education and Experience for CPAs. His monthly department in the *Journal of Accountancy* entitled "Accounting Education" was a source of information and guidance not only to students but to all concerned with accounting education.

Mr. Kane's work brought him into close contact with many important committees of the AICPA and his quiet energy and sage counsel will be sorely missed by the profession and by his many friends.

Standards of Probability Sampling for Legal Evidence

The use of economic data as evidence in many kinds of legal proceedings that originate in the business field has increased greatly in recent times. In an effort to formulate a statement of sampling standards acceptable to both lawyers and judges, The Society of Business Advisory Professions (two of whose officers are CPAs) appointed a special committee (with two CPA members) on Standards of Sampling for Legal Evidence. Its report, as well as a discussion of its contents, was recently published in cooperation with The Graduate School of Business Administration of N. Y. U., as No. 26 of the Society's *Current Business Studies.*

The report sets forth criteria that deal exclusively with specifications for probability sampling and does not consider the standards for judgment sampling. Probability sampling is a procedure by which one obtains a result from a selected representative portion of a total number of items that will be the same, within calculable limits of uncertainty, as the result that would have come from a complete coverage. The report recommends that if a study would be admissible evidence as a complete coverage of a certain frame, then it will also be admissible if it is carried out as a probability sample of that frame. An exception is made, however, if the precision of the sample is too low for the purpose, or if flaws in execution render the results questionable.

One of the disclaimers in the report states that the standards do not lay down criteria for making an audit of financial statements by professional accountants. Nevertheless, some interesting comments on sampling and auditing developed during the discussion period:

1. The sampling that has been done up to now in auditing work has not followed the standards set forth in the study. Accountants are very much interested in this technique and hope in

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ACCOUNTING NEWS AND TRENDS *is conducted by* CHARLES L. SAVAGE, C.P.A. *and member of the New York Bar. He is presently serving as chairman of our Society's Committee on Members in the Field of Education.*

Dr. Savage is professor of accounting and chairman of the Business Administration Division of St. Francis College.

time to arrive at some way to apply statistical approaches generally.

2. Auditors claim to have used subjective methods of sampling for many years and refer to this practice as judgment sampling. Statisticians do not readily accept this use of the term because of the failure of the auditor to define the "frame" and the items to be studied.

3. If properly organized by a trained statistician, the technique outlined in the report would help the auditor in dealing with masses of data such as accounts receivable in a department store, and certain inventories. It would also aid in setting up allowances against inventories or receivables.

Writing and Professional Success

The Editor of this magazine recently handed to this Department a booklet published by the Detroit Chapter of the NAA, entitled "Write Your Way To Success." Without adverting to the possible motives behind this transmittal, we are happy to summarize some of the ideas contained in this pamphlet.

Writing for publication is not easy and results only from careful thinking and painstaking effort. Any well-informed accountant, however, who is willing to devote the time and effort and has vital information and original ideas to transmit, can write an article and will be greatly rewarded thereby. It is a trite observation, but nonetheless true, that the writer of a paper always gets more out of it than its readers.

The NAA (and presumably this magazine) solicits manuscripts in three general categories — articles, accounting practice descriptions, and letters to the editor. An article is a comprehensive, well-rounded presentation which explores thoroughly a major problem of accounting or auditing theory or practice. An accounting practice description is a presentation of a practical application of accounting principles to a particular situation. A letter to the editor is a

brief expression of your viewpoint with respect to some accounting topic. Such a letter often expresses objections to an idea in a published article or seeks to clarify some point raised therein.

After pointing out that no formula exists for judging the quality of a manuscript, the report indicates that the following criteria, amongst others, are considered.

1. Timeliness or general interest of subject.
2. Originality of thought.
3. Evidence of thorough research.
4. Organization of material.
5. Excellence of composition and expression.
6. Excellence of charts, tables, sample forms, or other illustrative material.

A factor not mentioned, which would appear to be vital particularly for CPA practitioners, is that of informativeness on a suitably advanced level.

Clients are People

What are the most important things a beginning staff man should know for success in his accounting career? A group of supervisors of the Pittsburgh office of Arthur Young & Company set forth their answer to this intriguing question in that company's *Journal* (October, 1957) in an article "If You Had Only One Hour . . ." All of the 23 suggestions are worthwhile, but these two might be mentioned here:

1. Clients are the most important people with whom you work. Get to know them very well. For example, make an effort to learn everyone's name with whom you come in contact; learn what the business makes, the name of its raw materials and the names of its manufacturing processes.

2. Supervision of subordinates is a major responsibility of the senior accountant. If the junior does something wrong, it is very likely because the senior has failed to give proper supervision.

An Adirondack View

Too Much of anything is—well, it's more than enough—and that is usually bad.

In education, it makes one know too much about too little, or too little about too much. The first thing you know you become an egghead—what a terrible thing! Some one once said that if a person had plenty of brains he did not need to go to college, he could get it all faster and cheaper out of books.

In work, we are the boys who ought to know—we learn the lesson every year between January first and April fifteenth. If any of you don't know this one, go home and ask your wife.

Those who over do it tend to narrow themselves into deep ruts that introvert into circles, life goes round and round and, in the words of Wordsworth, the world becomes "too much with us."

LEONARD HOUGHTON, CPA
Saranac Lake Branch of
"The Adirondack Chapter"

Letters to the Editor

Retention of Accountants in Assignment Proceedings

The accounting fraternity should be interested in a new development which has arisen in the matter of the retention of accountants in assignment proceedings under the debtor and creditor law of the State of New York.

It has been customary, over a period of many years, for the retention of accountants to be made by the "assignee for the benefit of creditors" on the recommendation of creditors representing the largest and most representative number of claims. This is a practice which is followed as well in most proceedings under the National Bankruptcy Act and in those creditor situations which are conducted out of court. It is a practice which has been accepted and furthered by those organizations which represent groups of creditors in various industries and by the credit fraternity in general.

The Federal Bench has, to the best of this writer's knowledge, always acknowledged the right of creditors to suggest an accountant in insolvency proceedings under its jurisdiction. Unless there is knowledge of an adverse interest on the part of the accountant this recommendation will be accepted and the accountant will be retained by court order. In fact, the accountant, in an affidavit which must accompany the papers submitted, must state his independence of all parties in the proceeding.

In a recent decision of the New York State Supreme Court, however, the Judge did not recognize the selection of the accountant by the creditor's committee and designated an accountant appointed by the Court.

The following is a reprint of the Decision.

SUPREME COURT—SPECIAL TERM, PART I

(ASSIGNMENT BUREAU.)

By Mr. Justice Friedman.

In re Famous Upholstering Co., Inc. (Lindenbaum), Lamp Futures, Inc. (N. Y. Credit Men's Adjustment Bureau, Inc.), Navins Clothing, Inc. (Beck)—Orders signed.

Matter of Navins Clothing, Inc. (Beck)—The assignee presents a petition for the appointment of an accountant to perform necessary accounting services. This presents a problem about which this court has previously commented on a prior occasion when a similar application was made. The matter of assignments for the benefit of creditors has become a process through which creditors very rarely receive any funds. Ofttimes, after the payment of attorneys' fees, accountants' expenses, assignees' commissions and other expenses of the assignment, there is rarely enough to pay all of the tax claims, and even wage earners find themselves without relief. While technically, the court exercises some supervision over the assignment, actually it often has no such supervision. The assignor picks the assignee, who in turn selects the attorney. The assignee or the attorney selects the accountant, the appraiser, the auctioneer and the custodian. In effect, what is happening on many occasions is that the assignor makes his own selections of the people who will ostensibly protect the interests of the creditors, the government, city and state and the former employees of the assignor. It is for that reason that the court has heretofore stated, and now reiterates, that

wherever possible the court should appoint some one independent person in all of these assignment proceedings, whose duty it will be always to investigate the assignment proceedings. For that reason the court grants the present application to appoint a certified public accountant, but rejects the designee of the assignee, and the order has been signed designating an accountant appointed by the court. It is not intended by this memorandum to cast any reflection upon the accountants designated by the assignee, but this action is taken for the reasons previously stated. Order signed.

ROBERT A. WIENER, CPA
Roslyn, N. Y.

Conformity of Taxable Income and Fiscal Policy

We are indebted to Mr. Ira J. Palestin for his compilation of facts bearing upon the desirability of reporting the New York State personal income tax as a percentage of federal taxable income. Some divergent views are, nevertheless, suggested by his article which appeared in your November 1957 issue.

Mr. Palestin asserts that "New York is committed to the principle of substantial income tax uniformity between it and the federal" government. Why not *complete* uniformity? Mr. Palestin points out that the State would have to amend its rates with each change in the federal law. But we have frequent changes anyway. Maybe, with uniformity, we can avoid the confusion attendant upon fixing the rate for the year 1955 and the awkward computation we suffered with for 1955 and 1956.

The advantages of conformity are apparent. The taxpayer would be spared the trouble and expense of two income tax reports. Tax practitioners would enjoy some relief from the annual spring

agony. Changes by the federal government could be reported simply and accurately. The present procedure (form IT 115) is well devised, but still imperfect. Administration of the tax law in Albany would be simplified. The Legislature could confine its deliberations to the amount of revenue needed and the rates required to provide that revenue.

A broader consideration of all income taxes leads me to the conclusion that we are suffering with an obsolete form of revenue raising. Taxes should be easy to report, to pay, and to collect, and should be secure against evasion and avoidance. The income tax is none of these. It may have been a suitable form of taxation forty years ago, but it has outlived its usefulness.

A far more satisfactory tax would be a widely levied tax on transactions, to be reported and remitted only by business enterprises. Every mention of such a tax precipitates a deluge of objections, most of them arguing that a "sales" tax penalizes the poor. But those who believe that the income tax is levied in accordance with "ability to pay" are deluding themselves. The income tax is not a tax on income; rather, the income is determined by the tax for which it must provide. If we evaluate realistically the economic impact of the income tax, we find that it is only another cost of production, reflected in the prices of goods and services, therefore borne by all of us in proportion to how much we spend.

MAX L. NORCHICK, CPA
New York, N. Y.

From the Accounting Profession In Pakistan

We feel free to approach your goodself with a request to permit this Institute to reproduce in original form, in its monthly cost journal *Industrial Economist* some of the important articles appearing in your monthly journal, *The New York Certified Public Accountant.*

We feel that many of the articles in your journal, which deal on current problems and modern technical knowhow of accounting, business and economics, will be of immense benefit to our country for the following reasons, and we are sure that you will not deny us your cooperation, technical knowledge and experience in this regard:

1. Our country, though mainly agricultural, is now becoming semi-industrial and within the next few years or so, it will make a big stride in the industrial development.

2. Though our natural resources are vast and labour is abundant, we have

not been able to explore them fully, due to lack of heavy capital investments, sufficient technical know-how and the shortage of industrial accountants, industrial engineers and many others. At present there are very few industrial accountants and public accountants in the country who can make substantial contributions to the development and management control of our industry and business, and our (this Institute) purpose is to assist industry and business through the medium of our cost journal *Industrial Economist* and the like mediums (technical services, conferences, examinations, discussions, etc.) in solving national cost and economic problems of today and tomorrow.

3. Our industrialists, businessmen and all governmental agencies were not very much cost-conscious. Today they feel very strongly the need of the technical know-how of accounting, auditing, costing and budgetary control and business management for the effective control of their individual industry and business.

In the light of the above, we feel that our monthly cost journal, *Industrial Economist,* could serve the purpose of training the various management groups—top to down levels—in this field, as there is no other alternative at the present moment due to paucity of accountants. We are afraid, whether we will get regular contributions for our monthly journal from national industrial and public accountants and as such we feel by your doing this favour to this Institute you will be rendering great service to industry and business in this country.

Awaiting your early reply.

A. HUSSAIN
Managing Director, International Cost & Works Accountants Ltd., (Institute of Cost & Budgetary Control)
Karachi, Pakistan

Classified Section

RATES: "Help Wanted" 20¢ a word, minimum $5.00. "Situations Wanted" 10¢ a word, minimum $2.00. "Business Opportunities" 15¢ a word, minimum $3.00. Box number, when used, is two words. Closing date, 10th of month preceding date of issue.

ADDRESS FOR REPLIES: Box number, The New York Certified Public Accountant, 677 Fifth Avenue, New York 22, N. Y.

HELP WANTED

Accountant—CPA (male), supervising senior for 100 person CPA firm, familiar with audit administration and client relationship, experienced in supervision and review of accounting and auditing procedures, salary $14,000 with steady advancement, age 35 to 40. Box 1354.

SITUATIONS WANTED

Immediately Available, accountants, office managers, bookkeepers. Bookkeepers & Accountants Division, Maxwell Employment Agency, 130 West 42 St., N. Y. C., telephone LOngacre 4-1740.

Assistant Comptroller, CPA, law degree, presently employed, seeks better opportunity, over 25 years diversified experience, public and private, office management, financial statements, internal controls, credits and collections, taxes. Box 1334.

Tax Attorney, female, ten years with CPA firm, experience research, preparation returns, protests, Federal, State, local, $6,500. Box 1335.

Per diem, CPA with eight years of thoroughly diversified experience available 2-3 days per week. Box 1336 or WO 4-4368.

Accounting Work, etc., which can be done at home is wanted by conscientious, capable woman who passed CPA. Box 1337.

Comptometer Operator, wishes per diem work, diversified experience many fields, 12 years CPA experience, hours 9:30—4:30 mid or uptown New York, $17.00 per day. Box 1338.

CPA, attorney, 38 years, 8 years public, 2 years controller, seeks position leading to acquisition of practice or partnership interest. Box 1347.

CPA, young, 5 years public, 2 years private experience, currently chief accountant supervising 20 employees, seeks better opportunity in private accounting, will send resumé upon request. Box 1348.

CPA, LL.B., heavy experience audits, taxes, costs, budgeting, systems, desires per diem, 10-12 days per month. Write Box 1350.

CPA, Society member, 20 years diversified public practice, thoroughly experienced audits, taxes, reviewing, available per diem basis. Box 1353.

BUSINESS OPPORTUNITIES

Mail and Telephone Service, desk provided for interviewing, $6.50 per month, directory listing. Modern Business Service, 505 Fifth Avenue (42nd Street).

Justin Jacobs, Peter P. McDermott & Co., investment information, portfolio analysis, no charge for these professional services. DIgby 4-7140, 42 Broadway, New York 4, New York.

Statistical Typing, IBM typography, offset printing. Gitsham's, 480 Lexington Avenue, N. Y. 17, PLaza 5-6432.

Practice Wanted, substantial terms, know-how offered overburdened or retiring practitioner, CPA, N. Y., N. J., AICPA, IE, MBA. Box 1340.

CPA, AICPA, former partner small national firm with top level experience desires purchase of accounts or practice, New York area, prefer practice of about $50,000 gross, have profitable practice of about $40,000 and adequate cash capital, greatest tact and diplomacy, replies will be held in strict confidence. Box 1342.

Office for Rent, Lindenhurst, L. I., rare opportunity for CPA, beautiful offices in shopping center, 800 car parking. Call Karp, TUrner 8-1683.

Cleveland CPA, AICPA, will service your assignments in greater Cleveland area, daily or job basis. Box 1343.

CPA Firm, N. Y. C., having gross fees in excess of $200,000 seeks practitioner for merger purposes, having substantial quality practice in predictable fees, interested primarily in spreading top level responsibilities and perpetuation of firm, replies in strict confidence. Box 1344.

Established and Growing CPA firm will purchase practices or individual accounts, will offer attractive arrangements to those anticipating retirement or transfer. Box 1345.

Get A Fifth Avenue Office, without Fifth Avenue overhead, efficient, personalized, low cost mail, telephone, desk, specializing in accountant's requirements, private office space available. 516 Fifth Avenue Telephone Service at 43rd Street, MUrray Hill 2-3717.

BUSINESS OPPORTUNITIES

CPA Partners (2), seek to exchange with another CPA firm services for office space and service or merge practice with small firm. Box 1352.

CPA, has small private office for rent to young practitioner with possible affiliation opportunities. Guzik, 175 Fifth Avenue, OR 7-2200.

Private Office, midtown, suitable single practitioner, furnished, share use of Thermo-Fax, other machines and services, reasonable. LO 3-6526.

24 West 40th St., Room 905, CPA will rent attractive private office approximately 10½′ x 12½′, 2 windows, fluorescent lights, vinyl papered walls, carpeted floors, dignified reception room, additional space for secretary if required, lease, immediate possession. LA 4-3300.

CPA, N. Y., gross about $20,000 with downtown office desires association with practitioner, aim joint administration, other mutual benefits, or merger. Box 1346.

CPA, desires office space or office preferably Fordham Road area Bronx. WO 2-4259 or SYcamore 2-2759 or Box 1349.

We Are Looking For several CPAs who would like to rent dignified suite on an expense sharing arrangement. Box 1351.

The President's Page

Disclaimer of an Opinion

Ten years have elapsed since the issuance of Statement on Auditing Procedure No. 23 dealing with the disclaimer of an opinion with respect to financial statements taken as a whole. During that period the reporting principles governing the disclaimer have become an integral part of our thinking and our literature and are reflected in Standard of Reporting No. 4 of the Generally Accepted Auditing Standards. The members of the American Institute of Certified Public Accountants have just adopted a new rule of professional conduct which embodies the substance of that standard. The members of our Society voted in April 1953 to be bound by the principles of Statement No. 23, as revised, which have been incorporated in the *Codification of Statements on Auditing Procedure.*

It is very disturbing, therefore, to have our attention brought, from time to time, to instances in which these principles have not been observed. Although they may occur infrequently, we may nevertheless inquire as to why they should arise at all. Is it because of unfamiliarity with the principles themselves? Is it due to misunderstanding as to the form of disclaimer which may be used? Or has there been a slackening in professional vigilance? Whatever the reason, the fault should be corrected. To that end, the Board of Directors has authorized me to send to each member a copy of the pertinent provisions of the *Codification*, and a number of illustrative disclaimers prepared by our Committee on Auditing Procedure which may be used as guides and modified to meet particular

circumstances. It should be borne in mind that there is no standard form of disclaimer and that none is contemplated.

In circumstances where an opinion on the financial statements cannot be rendered, the use of an appropriately worded disclaimer will minimize the possibility of misunderstanding on the part of those who read the report. In the eyes of the informed reader, be he client, banker or credit grantor, the accountant gains in stature for his adherence to a highly desirable standard of reporting. If clients or others are unfamiliar with the reporting standards governing the rendering of an opinion or a disclaimer, it is up to us to educate them. But this can only be done if we, ourselves, are thoroughly familiar with these principles and observe them rigidly. The growth of our profession depends in large measure upon the maintenance of our high standards. This is the responsibility of all of us.

LEONARD PRICE,
President

Union Welfare Funds

By Raymond Buchbinder, C.P.A.

The audit of union welfare funds by independent certified public accountants is assuming increasing significance in the light of recent public interest. This article deals comprehensively with the operations of employer-employee managed welfare funds, and with related auditing procedures.

Employee-employer managed welfare plans operating under a trust agreement resulting from collective bargaining between a union and one or more employers, have been brought to the public's attention during the past few years due to various State and Federal investigations of improper practices. As a result of these investigations, an Ethical Practices Code for Health and Welfare Plans was promulgated by the executive council of the AFL-CIO, certain States adopted regulatory laws and Federal legislation is pending. The effect of these regulations and their specific requirements relative to accounting practices will be covered subsequently in this article. Embodied in each of these is the principle of full disclosure, with the requirement that the certified public accountant or licensed accountant prepare certain reports reflecting essential information. Hence, the auditor must be thoroughly acquainted with the applicable provisions of the pertinent laws and regulations, including the Taft Hartley Act and such basic documents as the collective bargaining agreement and the trust agreement. He should also have an understanding of government-labor-management influences. It is only by having this background that the CPA can effectively proceed with the examination of a welfare fund.

The terms "plan" and "fund" can be understood when it is realized that the plan is the trust agreement itself, and the fund, which is created by the plan, means the money or other things of value which are under the control of, or in the custody of, the trustees for the administration and operation of the plan.

Raymond Buchbinder, C.P.A., *is a member of our Society's Committees on Employee Welfare Plans and Funds and on Institutional Accounting. He is a partner in the firm of Buchbinder, Stein & Co., Certified Public Accountants.*

The Collective Bargaining Agreement

Welfare plans usually have their origin in a collective bargaining agreement which normally provides that they be administered under a separate trust agreement. The life of a welfare plan is coexistent with the life of the collective bargaining agreement creating it. The collective bargaining agreement may or may not detail the types of bene-

fits to be provided, but it usually specifies the amount of contribution to be made by the employer. Contributions are not usually required from either the union or the employees.

A sample type provision from a collective bargaining agreement follows:

"The employer agrees to pay ...... cents per hour, regular or overtime, worked by each worker to the XYZ Welfare Fund. Hours worked shall, for the purpose of this paragraph, include ......hours for each day of paid holiday, paid vacation and paid sick leave."

An agreement may provide in lieu of a specified sum per hour, for the employer to pay a flat percentage on each employee's earnings or a specified amount per day per employee. It further provides for the frequency of payment, reporting of the payroll and other necessary information for the proper administration of the plan, as well as for the examination by the plan of the employer's payroll and other pertinent records.

A copy of this collective bargaining agreement should be an integral part of the auditor's work papers. Although rules relative to the determination of coverage and reporting of payroll data by the employer may be detailed in this agreement, they are always contained in either the trust agreement or in the minutes of the trustees' meetings.

Government Interest In Adequate Reporting

It was the "Labor Management Relations Act of 1947," commonly known as the Taft Hartley Act, which required the establishment of a trust for the operations of these plans. Section 302 of this Act, as amended, made it unlawful for any employer to pay any money or thing of value to the union or its representatives, except the making of contributions to a jointly operated trust fund for welfare and other similar purposes.

Under Section 302 (c) (5), the funds are to be held by a trust, jointly operated by representatives of the employees and employers for the benefit of the employees, their families and dependents, for the purpose of paying for "... medical or hospital care, pensions on retirement or death of employees, compensation for injuries or illness resulting from occupational activity or insurance to provide any of the foregoing, or unemployment benefits or life insurance, disability and sickness insurance, or accident insurance . . ." However, a separate trust must be created for funds paid in to provide pensions or annuities.

The trust must further provide for the settling of deadlocks on the administration of such fund, for annual audits with "a statement of the results" of the audit available for inspection.

Although this Act provides for annual audits of the funds, it was not motivated towards correcting welfare fund abuses but ". . . to provide additional facilities for the mediation of labor disputes affecting commerce, to equalize legal responsibilities of labor organization and employers, and for other purposes." However, because of the disclosures of welfare fund abuses by the McClellan Committee, there is ample evidence that the next session of Congress will pass special regulatory legislation.

Opinion of counsel for the plan should be obtained for assurance as to the conformity of the plan with the requirements of the Act. The plans which are subject to this Act are frequently referred to as "Taft Hartley Plans."

Several bills were presented at the last session of Congress proposing to

place welfare funds under the jurisdiction of the Labor Department[1] or the SEC.[2] In the closing session of the 85th Congress, First Session, Bill S 2888, "Welfare and Pension Plans Disclosure Act," was reported out of the Committee on Labor and Welfare Plans. This bill places the registration, reporting and disclosure of these plans under the jurisdiction of the Department of Labor. All plans will be required to register, and those plans covering more than 100 employees must file an annual report within 120 days after the close of the fund's calendar or fiscal year.

All these bills require the issuance of reports, certified to by an independent public accountant, based upon a comprehensive audit made on behalf of the beneficiaries, with the specification that certain designated items are to be disclosed. As listed in Bill S 2888, these items are: "the amount contributed by the employer or employers; the amount contributed by the employees; the amount of benefits paid or otherwise furnished; the number of employees covered; a detailed statement of assets, liabilities, receipts, disbursements, and other financial activities of the plan; the salaries and fees charged to the plan, to whom paid, in what amount, and for what purposes."

The present Federal reporting regulations consist of the annual filing of Treasury Department Form 990, if the plan qualified for exemption under Section 501 (a) of the Internal Revenue Code of 1954 and received exempt organization status.

New York was the first State to pass a regulatory bill placing all plans either under the Superintendent of Insurance or Superintendent of Banks.[3] The State of New York in 1954, under the Superintendent of Insurance, made a survey and examination of welfare plans in the State and reported its results to the legislature. It was found that in many of those plans which gave evidence of abuses, there were such deficiencies as improper record keeping, failure of trustees to attend meetings, and lack of periodic audits by certified public accountants.[4]

California, Connecticut, Massachusetts, Washington and Wisconsin have enacted legislation requiring registration and filing of annual statements by funds. Duplicate filing for funds which operate in more than one State may be avoided by requesting a waiver of the filing requirements.

Reporting Under New York State Law

Each plan operating in New York must register within three months after commencing business in the State. A form "Registration Statement for Employee Welfare Funds" is provided by either the Superintendent of Insurance or Superintendent of Banks, depending upon which agency has jurisdiction. Generally the Superintendent of Insurance has jurisdiction since the Banking Department is primarily concerned only with those plans having a corporate trustee (bank) which is subject to supervision by the Superintendent of Banks, or is a member of the Federal Reserve System. If the principal office of the employer is located outside the State, registration is required of the plan if at least 20 employees are employed in the State.

Thereafter, annually within five months after the fiscal closing date, an annual statement of the fund, in duplicate, is to be filed. To facilitate the preparation of this statement, the auditor must be familiar with its contents and have the books set up so that the information is readily obtainable. The in-

formation called for in the 19-page statement for 1956 is summarized as follows:

Statement of assets, liabilities and unassigned funds; summary of operations and unassigned fund account; exhibits reflecting analysis of interest, dividends and real estate net income; profits and losses on disposal of investments; increases and decreases by adjustment in asset values of investments; statistical data re: experience under insurance contracts with amount of commissions and allowances paid by the insurance company; benefits directly provided to members; general expenses; professional fees including names and addresses; salaries, allowances and travel of officers and trustees, and others who exceeded $5,000 per annum; schedules reflecting real estate owned with provision for income received, name of vendor, cost, etc.; mortgage loans with all details re: mortgage, interest and insurance; bonds owned including their cost, market value, book value, interest received and name of vendor of the securities; stocks owned including cost, market value, book value, dividends received and vendor; cash in banks by depository and interest received.

An annual report is also filed within the same time limit. This report is a short summary of the annual statement and it is required that a copy of the report be sent to each employee member, contributing employer and participating labor organization. Publication in the union's newspaper is authorized in lieu of the above requirement for mailing to employees.[5]

Labor's Interest

Although the auditor is vitally concerned with the plan's compliance with all Federal and State regulations, he must also be aware of the requirements and desires of labor regarding the financial policing of such plans.

The AFL-CIO in their first convention held in New York on December 5, 1955 immediately after their merger, adopted a statement of principles on the administration of health and welfare funds, to prevent abuses and thus protect the beneficiaries thereunder. On January 31, 1957 the AFL-CIO executive council approved "Ethical Practices Code II" dealing with health and welfare funds.[6] This Code was based upon those principles adopted at the first convention. The CPA should have a knowledge of the Code's provisions so that he will understand the character of the matters which call for appropriate report disclosure.

In summary, the Ethical Practices Code II states that:

1. Officials who received full-time pay from their union should not receive fees or salaries from a welfare fund.

2. Union officials, employees, their agents or representatives, should be entirely free of any compromising personal ties, direct or indirect, with outside agencies such as insurance carriers, brokers, consultants and others doing business with the welfare plan.

3. Complete records of the financial operations of the fund shall be maintained in accordance with the best accepted accounting practice and the funds should be audited regularly by internal auditors, and annually or semi-annually by certified public accountants or other independent accountants of unquestioned professional integrity, who should certify that the audits fully and comprehensively show the financial condition of the fund and results of the operations of the fund.

4. All audit reports should be available to the membership of the union and the affected employees.

5. There should be full disclosure and report to the beneficiaries at least once a year. This report is to include: a detailed statement of receipts and expenses; all salaries and fees paid by the fund, to whom, and in what amount these funds were paid, and for what service or purpose; a breakdown of in-

surance premium payments, if a commercial insurance carrier is involved, showing the amount of claims paid, dividends, commissions, retentions and service charges, and to whom the carriers paid these commissions and charges.

6. If the plan is to be insured, then the commercial carrier should be selected through competitive bids and the carrier who is finally selected should warrant that no fee or other remuneration has been paid, directly or indirectly, to any representative of the parties in connection with the business of the fund.

7. Funds should not be invested in the business of any contributing employer, insurance carrier, or agency doing business with the fund, or in any enterprise in which any trustee, officer or employee of the fund has a personal financial interest of such a nature as to be affected by the fund's investment or withdrawal of investment.

8. Where unethical payments have been received by any trustee, whether employer or employee, or any employee of the welfare plan, the union should insist upon his removal and appropriate legal action taken against both the party receiving and the party making the payment.

9. There should be an adequate procedure for an appeal to be taken by any beneficiary against the arbitrary or unjust denials of claims. Complete records of the claims experience must be maintained.

10. The duty of policing and enforcing these standards is to be shared by every union member, as well as by local, national and international officials.

The Welfare Trust Agreement

The Trust Agreement, otherwise referred to as a Declaration of Trust, provides for the management of the plan by trustees, of whom an equal number are appointed by the union and by management. This agreement will contain provisions covering the following points: a restatement of purpose, contribution rate, eligibility for benefits, trustees' authority and duties (which usually require the keeping of accurate books and records), provision for an audit by a CPA, employee-employer rights, termination, investment of funds, arbitration, and miscellaneous items.

In addition to mention of administrative procedures, the general nature of acceptable expenditures is detailed in the trust agreement or in the minutes of the trustees' meetings. The auditor refers to these to determine if the expenditures of the fund are being properly disbursed. The responsibility for the operation of the plan and the interpretation of the provisions of the agreement rest solely with the trustees. At their meetings they designate the depositories for the handling of the fund, authorize fidelity bond coverage, appoint an administrator, retain counsel, engage a CPA firm to assist in the setting up of its system and to perform periodic audits, engage an actuary and medical consultant if the plan is self-insured, determine frequency of meetings, create or modify benefits and eligibility, establish rules and procedure, interpret the trust agreement where required, set up an investment program for the reserve and surplus funds and determine if benefits are to be insured or self-insured.

Emphasis on Adequate Disclosure

It is evident, after referring to the Taft Hartley Act, the Ethical Practices Code of the AFL-CIO, the laws of the State of New York, the reporting forms required by the Superintendent of Insurance or Superintendent of Banks, and the proposed Federal law, that the emphasis is on adequate disclosure. There

is a similarity in the various rules and regulations which are designed to eliminate abuses. The majority of these abuses were the result of employees or employers who did not deal with the funds at arms length.

The auditor's report enables the trustees to more readily understand the operations of the fund and determine if there are any abuses to be corrected. Therefore, additional schedules should be included to reflect the following: all trustees' expenses; professional fees; traveling expenses; appraisal fees; administrator's salary, fees and expenses; salaries of all employees and officers by name; schedule of investments with all details relative to the vendor; all purchases of fixed assets, whether or not they have been expensed, including names of vendors; all commissions and other fees paid with the names and addresses of the recipients.

If the above schedules do not disclose payments made to representatives of the union or any official or employee thereof and to any employers or their officials and employees, then a separate schedule should be included.

The auditor should notify the trustees, by letter, if he uncovers any other transactions between the fund and the employers or the union, or any of their representatives.

If in the judgment of the auditor the detailed schedules do not in themselves provide full disclosure, pertinent textual report comments should be made.

The Trustees seek the advice of the auditor and counsel for the plan regarding their accounting and legal responsibilities. The Trustees normally serve without pay and perform their duties as trustees in addition to their regular positions either with the labor union or with the employer.

The Trustees can be surcharged for any improper actions which result in a diminution of the plan's funds. Certain of the States' laws which require registration have provisions for fines and dismissals. The auditor can thus render valuable assistance to the trustees to enable them to avoid liability and can also suggest the necessary procedures for the detection of violations. He can recommend that the trustees: obtain from the insurance carrier (selected through competitive bids if one is used to insure the plan's benefits) a statement relative to all fees and commissions, etc., and to whom paid, and statements from those individuals as to retention or disposition of the sums in question; approve all purchases of fixed assets and all other expenditures that are not part of the day-to-day administrative functions; approve the retention of any advisory or consultant personnel or firms who should outline in writing the services to be performed; require that all large expenditures for fixed assets, stationery and printing, etc., where practicable, should be made only after competitive bidding; and approve all periodic payments, whether under leases or otherwise. If these payments are made to a closely held corporation, a statement listing its officers and principal stockholders should be obtained from that company. An examination of the fund's transactions enables the auditor to recommend other safeguards so that full disclosure is made to the trustees.

Disclosures to the trustees not only serve to reveal abuses or to heighten understanding of the plan's operation, but also may possibly suggest to the trustees that their intent or the requirements of the trust are not being carried out. The trustees rely on the auditor, in areas of financial operations and administrative procedures, for advice as to whether the administrator is properly carrying out their policy. There may be occasion where discretion was exercised by the administrator in the payment of beneficiaries' claims in viola-

tion of the rules. In such instances, the action must be referred to the trustees. Where interpretations of the trust agreement or the minutes relating thereto are involved, the auditor should request a legal opinion from counsel for the plan. The CPA should attend all trustees' meetings to acquire a first-hand familiarity with the intent of the trustees and to be available for consultation on accounting matters.

Relationship With Insurance Carrier

Plans which insure all or a part of their benefits, enter into a contract with an insurance carrier to provide for those benefits for a specified time, usually a year. The terms, conditions, rules and regulations for the insured benefits to be paid are incorporated in the insurance contract. These should be in conformity with the trust agreement or the minutes of the trustees' meetings.

In order to safeguard the fund, carriers should be selected through competitive bidding by reliable companies. All bids should be submitted by a carrier on their stationery over the signature of a home office official. This tends to eliminate collusion by a broker in securing friendly bids favoring a particular insurance company. To determine the reliability of a carrier, reference can be made to Best's Insurance Reports.[7] The plan's office should have on file a statement from the carrier selected showing the amount of any fees, commissions or other allowances, and to whom these payments were made. The misappropriation of these payments was one of the abuses disclosed by the investigating agencies. In view of this fact, the plan should request a statement from each recipient of these fees, commissions or allowances to determine if he paid any of these monies or other thing of value to any person, directly or indirectly, connected with the plan. The auditor should review these statements to ascertain if there are any items requiring disclosure.

It does not necessarily follow that the company making the lowest bid will also, at the end of the policy year, have the lowest net premium cost (total premium less dividend) to the plan. This net premium is contingent upon the profit or retention of the carrier on this contract, as the amount of profit or retention determines the amount of dividend. Therefore, at the end of each policy year, which should coincide with the fund's fiscal year, the auditor should have the plan request a complete statement from the insurance carrier, analyzed by each benefit covered, showing the total amount of premiums received, the benefit claims experience, dividends and experience rating, refunds, commissions, fees or other allowances paid, administration expenses charged, taxes and retentions. The plan's representative, the auditor and the carrier should review the figures contained in the statement so that it can be determined if the carrier's charges or retentions are excessive. The information contained in the carrier's statement should be made part of the auditor's annual report.

Dividends are made known at the end of a policy year and if this year differs from the fund's fiscal year, the statement of receipts and expenditures on the auditor's annual report will not reflect the net premium cost for the period under review. When the fund's fiscal year and the carrier's policy year are not the same, the trustees may request the carrier to change the anniversary date of the policy so that it will conform with the fund's fiscal year. The inclusion in the report of the dividend as a receivable, or as a comment, will depend upon whether the accrual basis or cash basis is used.

The carrier usually allows the fund to do all administrative work in con-

junction with the presentation of the claims, such as obtaining of claim application and the necessary proof to substantiate it.

Any communication or payments regarding the insurance policy should be made directly to the carrier with a notification to the broker.

Contributions From Employers

In sending their contributions to the fund, employers report detailed information relative to the identity of each employee covered and the calculation of the amount of contributions applicable to him. This information is posted to an employers contribution ledger which is a subsidiary record for the recording of these periodic contributions. The contribution ledger contains date of receipt, period covered, amounts contributed, total hours, days or other contribution basis on which the amount is calculated. Other information relative to contributions which may be of importance to the particular fund is also included. By reviewing this ledger which reflects the payroll periods reported by the employers, it can be determined if any periods are not accounted for. To verify the mathematical accuracy of the employers contribution report, the auditor should multiply the contribution rate by the total of days worked, hours worked or total payroll, since the agreed upon contribution rate is usually the same for all employees covered by the plan.

A schedule of the total contribution from each employer for the period under review, which is to be included in the auditor's report, is obtained from this employer contribution ledger.

Periodically, confirmations should be sent to each contributor. On this confirmation, it is advisable for the auditor to insert the details of the individual contributions received so that the contributor can readily check this to his records. A photostat or other reproduced copy of the employers contribution ledger card can be attached to the request. It must be remembered that this confirmation only confirms the contribution sent to the fund and does not provide assurance that the amounts paid were properly computed in accordance with the trust agreement. Since the contributor is obligated to pay under the terms of this agreement certain monies representing so much per man per day, so much per hour worked or on any other agreed basis, the auditor must make an independent check to determine if the employers are paying the full amount of contribution required of them. This can be accomplished by a visit to the employer's premises to examine his payroll records. Another procedure would be to have the shop stewards of the union, who work on the employer's premises, periodically send spot-check reports to the plan listing the employees' names and number of days or hours worked. If this is not feasible, the shop stewards could send a weekly additions and deletions report reflecting employees added to or removed from the payroll. This report is compared to the employer's report to verify personnel changes. In addition, the application which the employee submits for benefits and which contains current employment data, may be used as supplementary evidence for substantiating employers' contributions.

A confirmation should be sent to the union requesting a list of new companies which had become parties to the trust agreement during the period under review. This enables the auditor to maintain an up-to-date schedule, in his permanent file, of the employers who are parties to the plan, and may be used to account for all of the contributing employers. Also, it is compared with the employers' reports from the new

companies to determine if the starting date of their contributions corresponds with the dates they joined the plan.

The plan should have on file a signed trust agreement for each of the contributors. A discussion with the plan's counsel will assist in clarifying any question concerning the liability of the employers under the trust agreement.

Investments

A schedule of all investments should be included in the auditor's report and should reflect the following: for bonds —name and description, interest rate, maturity date, cost, principal amount, book value at amortized cost, market value, interest payment dates; for stocks—name and description, number of shares, cost and market value.

If the portfolio of investments is held by the plan, a physical count must be made. If the portfolio is held by a custodian, direct confirmation must be obtained.

The CPA should consult with counsel to determine that the Trustees are investing the funds in accordance with the expressed or implied provisions of the trust agreement and that they are complying with State laws.

Investment income, resulting from the investment of the plan's reserve or surplus funds, should be checked in detail to the plan's portfolio to determine if all the income from securities has been received during the period under review. Published services for dividends and stock rights should be referred to.

High-grade, long-term bonds purchased at a premium or discount, should be carried on the books at amortized cost.

Premium Payments

Premium payments to the insurance carrier are usually made on a monthly basis, payable in advance. This payment should be checked to the policy to determine if the correct rate was used. Further, the auditor should check to see that the payment covers the correct number of eligibles. To accomplish this, reference must be made to the eligibility rules and to the individual employees eligibility record. (Employees eligibility records are discussed under "Benefit Claims.") Since the number of eligibles vary within the premium payment period, separate calculations should be made for subsequent periods.

Underpayments, because of improper record keeping regarding eligibility, create a potential liability of the fund to the carrier, and, conversely, overpayments represent an excessive cost which, if discovered, is recoverable.

Direct confirmation of the premium payments to the carrier is unnecessary since this payment can be checked to the carrier's statement issued at the end of the policy year.

Benefit Claims

Benefits provided by welfare plans usually cover payments for death, hospitalization, medical, surgical, disability, maternity and unemployment for employees and their dependents. These benefits, if insured, are paid by the carrier, and if self-insured, are paid from the plan's funds.

Coverage for New York State disability benefits, which is required by employers under the laws of the State of New York, may be provided by the plan after qualifying as a "covered employer."[8] The plan must qualify with the Workmen's Compensation Board by filing Form DB 801, and the employers file Form DB 802, requesting that the Board accept the plan as the employer's plan. After the plan is qualified and designated as a covered employer, the employers are relieved from providing

coverage for that group of his employees who are covered by the plan.

It is to be noted that the payment of pension benefits by a welfare plan is prohibited under the Taft Hartley Act unless a separate trust is created for pension payments. Also, the Internal Revenue Service will not grant an exemption to the plan if both pension and welfare payments are paid by the same plan.

When an employee is entitled to receive benefits, he fills out the appropriate benefit claims application form, which are standard forms of the plan. These forms request certain basic information, such as, name, address, social security number, employment number, date of birth, marital status, last employer worked for, type of claim, length of employment, name and age of dependents and other data to support claim. This form can provide for any other additional information which the plan needs to determine if the eligibility requirements for a particular benefit have been met.

A claim folder is made out for each application received. A claim is given a numerical number and coded according to type of claim. This claim folder, which is a permanent file, should contain the application of the claimant and other supporting documents. The death claim folder should contain a copy of the death certificate, a copy of the beneficiary designation, the calculation showing the eligibility of the claimant at the time of death, and letters of administration where no beneficiary had been designated. If the beneficiary is the wife, a marriage certificate may be required for the purpose of identification.

The other claim folders (hospital, medical, surgical, etc.) should contain the application with the pertinent information thereon, the calculation showing that the eligibility was checked and the necessary invoices to support the cost of the claim or the amounts of money to be paid. These invoices are those from the doctor, the hospital, or from anyone who rendered services which are reimbursable. If the claim folder reveals that there is a questionable payment, then a letter, incorporating all such items, should be written to the trustees for their action. The trustees are thus alerted to a departure from normal practice.

To facilitate the processing of benefit claims, it is essential that two basic records be established—an employee eligibility card and a record of benefits paid. The detailed employment information contained in the report received from the employers is posted to the eligibility card maintained for each employee. A record of previous claims paid can also be incorporated on the employee eligibility card so that when a new claim is received, a check of this record card will indicate if previous benefits have been paid. The individual's claim folder can then be examined to determine if his benefits have been exhausted.

The record of benefits paid is merely a detailed breakdown of all benefits paid by the fund or insurance carrier and provides the total dollar amount of each type of benefit and the total number of claims paid. It may be a separate subsidiary record or, in the case of self-insured plans, can be a part of the general ledger.

The reports required to be filed with the New York State Insurance and Banking Departments also require a detailed breakdown of benefits paid.

Under self-insured plans, consultations should be held with the actuaries to determine if additional information is required on the employee eligibility card and the record of benefits paid to facilitate the actuarial study.

If the plan is paying a benefit, based on a temporary or permanent disability, this benefit is usually contingent upon

the fact that the claimant is not employed. Therefore, a test of the reporting forms or payrolls received from the employers, will reveal if any disability claimants appear thereon. Beneficiaries receiving total and permanent disability payments should be prepared to submit, at regular intervals, a medical report verifying that they are still disabled and a statement showing the source and receipt of earned income, if any.

Surgical benefits are paid in accordance with a schedule which lists the maximum fees payable for numerous types of operations. It may occur that the surgeon's description of the services rendered is not similar in terminology to that appearing on the surgical schedule and, therefore, the amount of fee to be paid cannot be determined. Further inquiry must be made of the plan's medical consultant for the determination of the proper fee consistent with this schedule.

Although under an insured plan, the carrier checks all claims and is responsible for payment of these claims, it is a fallacy to assume that the auditor does not have to concern himself with testing them. Instances can arise where the insurance carrier may approve certain claims on the basis of too liberal an interpretation of the rules, or may unduly limit their payments. This is another type of situation which should be reported to the trustees as it is their responsibility to make the interpretations which should be placed upon the rules and regulations. When the carrier improperly makes payments based on a liberal interpretation, each and every claim paid adversely affects the dividends and could affect the current year's budget for insurance cost. When claims exceed the premiums, an increase in the future years' costs can be expected.

Under a self-insured plan, the checking of the benefit claims performed should be more extensive than the check performed for an insured plan since, in the latter case, the auditor places some reliance on the carrier who checks all claims paid. When self-insured plans operate on a cash basis, it is important for the auditor to take off a schedule of death benefits pending, to see if there is an unusually high liability for outstanding benefit claims which necessitates a comment either in the report or on the schedule of benefits. For the other pending benefits, a schedule may not be required since these claims are normally processed within a shorter time than death benefit claims. On the accrual basis, the liability for all outstanding claims would be included on the auditor's report.

Other Expenditures

When auditing expenditures, careful scrutiny is essential to determine the transactions which require specific disclosure in either the auditor's report or in any report to a Federal or State agency.

A plan can acquire fixed assets for the purpose of providing benefits, supplementing existing benefits and for administrative purposes. A medical or recreation center is an example of the acquisition of fixed assets to provide benefits.

Fixed asset expenditures are written off to expense when acquired, with offsetting credit to a reserve account. Although this expenditure is of a capital nature and has continuing value, the inflation of the fund balance by its capitalization, can be misleading. The trustees look to the availability of the fund balance before they decide on a new benefit or the extension of an existing one. The financial reports issued by a fund are not used for credit purposes. However, to retain suitable accountability, the plan's records should reflect in

a fixed assets ledger a complete listing of the acquisitions at cost, with the total agreeing with the controlling fixed asset and related reserve accounts. A schedule listing the owned fixed assets should be included in the auditor's report.

Expenditures are classified into three groups — benefits, administrative, and others. Under the expenditures for benefits are included insurance premiums paid for insured benefits, benefits paid directly by the fund if self-insured, and the write-off of fixed assets acquired to provide or supplement benefits. The administrative expenditures are the office operating expenses, the expenses for leasehold improvements and the write-off of all office furniture and fixtures. The other expenditures include trustees' meetings expenses, legal, accounting and actuarial fees, and other items similar thereto.

Reserves

Self-insured plans should set up "reserves for contingencies" and "reserves for outstanding benefit claims." The responsibility for the amount of these reserves is not one for the auditor, but for the actuary. The self-insured plan should employ an actuary for the purpose of examining the actuarial soundness of the fund. He computes the contingency reserve for each of the benefits. The auditor's report should show the total of the individual contingency reserves for each of the benefits under the heading "Reserve for Contingencies."

The "reserve for outstanding benefit claims" covers the liability for unfiled claims which will be applicable to the period under review. These are not to be confused with the accruals for the claims on hand but unpaid. Under a cash basis method of reporting, these accruals need not be set up.

The actuary's report also indicates the amounts of money it estimated would be paid, during the ensuing year, for each benefit provided under the plan.

The adjustment to the reserves is usually made on an annual basis after the actuarial review. However, if during the year the claims paid exceed the amount estimated for that year, then a charge may be made to the "reserve for contingencies" for the excess payments. The auditor's comments should state that these reserves were set up in accordance with the actuary's report. The auditor's report should likewise contain a statement of changes in reserve balances.

Taxes

After a welfare plan has been operating for one year, it may apply for exemption from taxes under Sec. 501 (a) of the Internal Revenue Code of 1954, by filing Form 1026. This type of organization is referred to in Sec. 501 (c) (9) and will receive an exemption provided it meets the requirements set forth therein, namely, that "(A) no part of their net earnings inures (other than through such payments) to the benefit of any private shareholder or individual, and (B) 85 per cent or more of the income consists of amounts collected from members and amounts contributed to the association by the employer of the members for the sole purpose of making such payments and meeting expenses."

After the organization receives its exemption, Form 990 is filed annually.[9] The date for filing the annual return is on or before the fifteenth day of the fifth full calendar month following the close of the period for which the return is required to be filed. Annual information return 990 may not be filed until the trust has received its exemption. However, if the exemption is not granted prior to the due date for filing the first return, an extension for filing

may be applied for.[10] If this is not done, or if the exemption is not granted, a trust return must be filed.

The various states imposing income taxes usually exempt those trusts which have received an exemption from the Internal Revenue Service. If an extension has been applied for from the Service, a similar application is made to the State.

The contributions to the trust by the employers are deductible as an ordinary and necessary business expense in accordance with Section 162A of the Internal Revenue Code.[11]

The employer contributions do not constitute gross income to the employee on whose behalf he is paying,[12] nor does the amount that the employee receives in benefits constitute taxable income to him.[13]

The Auditor's Report

It is advisable that the auditor's report be prepared on a cash basis. The trustees prefer this basis as it enables them to discern the cash flow more readily and to determine the liquid funds available for future expenditures. The cash basis can properly reflect the condition of a welfare fund; if the total of contributions which are received currently, exceed the total of the cost of benefits, administrative expenses and reserve requirements, then there will be sufficient cash available to pay all bills upon receipt. Consequently, the unpaid liabilities at the end of the accounting period would not be of a material amount. This basis also lends itself to the preparation of the annual statement required by the State of New York. Of course, if the above conditions do not exist, the accrual basis may be used.

As a result of the publicity regarding improper practices in the handling of certain welfare trust funds, a great deal of reliance will be placed upon the auditor's report. Therefore, in expressing an opinion, the auditor should be guided by Statement on Auditing Procedure No. 28 which deals with the applicability of reporting standards in special circumstances such as those of non-profit or service organizations. This bulletin also suggests the form of opinion the auditor should use for cash basis reporting on this type of organization, as follows:

> "In our opinion, the accompanying statements present fairly the assets and liabilities of the XYZ Company, at December 31, 19 , arising from cash transactions, and the revenues collected and expenses disbursed by it (and changes in proprietary interest, fund balances, etc., where reflected in cash basis statements) during the year then ended, on a basis consistent with that of the preceding year."

Unless an opinion can be expressed, careful consideration should be given concerning the releasing of the report, even with a disclaimer, on the auditor's stationery, because many employees may not understand the significance of a disclaimer and may not recognize the report's limitations.

The long-form report is preferred because the trustees, employers, union and the employees, require an intimate knowledge of the plan's financial affairs. The long-form report comments are of the explanatory type and should begin with a short summary of how the plan was established, the date, who the signatories are, and the terms. A sample opening for these comments would be ". . . . . Welfare Plan, which provides for the establishment of the . . . . Fund, was established under the provisions of an agreement and declaration of trust made as of . . . . between the . . . . Union and the signatory employers. Under the terms of the agreement, the welfare plan was to continue for . . . . . years to . . . . and could be extended from that time." If the plan has been extended then a para-

graph should be added stating that under the collective bargaining agreement entered into on .... between the union and its signatory employers, the plan was extended to ....

Thereafter, there will follow, under a series of sub-headings, explanatory comments which describe the various financial statement items and the fund operations related thereto. Frequent reference has been made in this article to those significant matters which require comment.

In addition to the basic financial statements (balance sheet, frequently termed "Composition of Fund" in welfare fund accounting; statement of receipts and expenditures; and statement of changes in fund balances), the following is illustrative of the type of supporting schedules which may appropriately be included in the report:

Benefits Paid (if self insured)

Insurance Carriers Experience (if insured; list, by type of benefit, premium paid, claims paid, expenses charged, dividends, carriers' retention, etc.)

Administrator's Office Expenses

Salaries (list names, job classification and amounts)

Trustees' Meetings Expenses (list names and amounts)

Professional Fees (list names and amounts)

Travel Expenses (list names and amounts)

Investments

Fixed Assets (cumulative, with designation of current acquisitions)

Contributions by Employers (list names of employers and the amounts contributed during the period)

The inclusion in the report of the schedule of salaries of the plan's employees showing their names, job classification and amount received should be discussed with the trustees and the administrator, as this inclusion may create personnel problems. This schedule may be eliminated if the divulgence of this information operates only to the plan's disadvantage and there are no excessive salaries or other unusual circumstances which require disclosure.

After the completion of the annual report, the auditor should recommend to the trustees that it be printed for mailing to the contributing employers and to the beneficiaries, if practicable. If there are large numbers of beneficiaries who cannot be reached by direct mail, or the cost of reaching them would be prohibitive, the trustees may request the union to publish the auditor's report in their periodical. If a condensed version is used because of space limitation and the auditor's certificate or name is mentioned, he should reserve the right to approve the presentation.

References

1. HR 487; HR 4653; 85th Congress, First Session.
2. S 1122 and HR 6513, 85th Congress, First Session.
3. Employee Welfare Fund Act of 1956, Sec. 37 of Article III A of the Insurance Law; Sec. 60 of Article II A of the Banking Law.
4. State of New York, Insurance Department, "Whose Welfare?" A Report on Union and Employer Welfare Plans In New York, December 6, 1954.
5. Regulation No. 36, State of New York Insurance Department; Employee Welfare Fund Regulation No. 1, New York State Banking Department.
6. AFL-CIO Codes of Ethical Practices, Publication No. 50, reprinted in *The New York Certified Public Accountant*, August 1957.
7. Best's Life Insurance Reports; Best's Insurance Reports, Fire and Casualty Edition (Alfred M. Best Co., Inc.).
8. Workmen's Compensation Law, Sec. 211 (4) (5).
9. Reg. 1.501 (a)-1(e)(1), 1954 IRC.
10. Rev. Rul. 54-393, IRB 1954-37, 15.
11. Rev. Rul. 56-102, IRB 1956-12, 5.
12. Sec. 106, 1954 IRC.
13. Sec. 105, 1954 IRC.

Revenue Rulings of 1957 Affecting Individuals

By Samuel A. Dyckman, C.P.A.

The number of rulings published in 1957 interpreting the provisions of the 1954 Code exceed by far the rulings released by the Internal Revenue Service for the prior year. In order to present a workable analysis of the rulings, and, to permit further study of the tax points involved, they have been summarized and grouped by subject matter. This article deals with those rulings which basically affect individuals although many of the principles are equally applicable to other taxable entities.

Contributions

Contributions made to a fraternal club to help defray sickness or burial expenses of a deceased member are considered contributions to individuals and are not deductible. (57-188). Similarly, payments to a State Hospital to reimburse the State for the care of a patient do not constitute deductible contributions or gifts to or for the use of a State for exclusively public purposes. (57-211). However, contributions to committees organized to carry out the "People to People Program" (set up under the Federal Information and Educational Exchange Act to foster mutual understanding between peoples of all countries), and out-of-pocket expenses incurred by individuals in forming and rendering volunteer services to such committees, constitute allowable deductions as contributions made to or for the use of the U. S. (57-38). Also, amounts contributed to the U. S. Commissioner of the 1958 Brussels World's Fair are considered gifts to or for the use of the U. S. for exclusive public purposes. (57-419). Values attributable to land which, in connection with the taxpayer's sale of lots, was required to be released to a county for the widening of a road, cannot be deducted as a charitable contribution but must be added to the cost basis of the remaining property. (57-488).

Where the owner of a work of art makes a gift of a future interest in the work, reserving the right to its use and enjoyment during his lifetime, a charitable deduction for the present value of the remainder interest will be allowed. The owner may also make a gift of a portion of an undivided present interest in an art object, in which case the fair market value of such interest will be allowed as the deduction. (57-293). A charitable contribution deduction is al-

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lowed for the present market value of a gift to a State of an undivided present interest of one-fourth of a residence to be used as a Governor's Mansion. (57-511). Should an individual contribute "Section 306" stock to an exempt foundation, no income will be recognized on the transaction, while a deduction will be permitted for the full fair market value of the property. (57-328).

The board of directors of a corporation may authorize a contribution during a taxable year, and if the contribution is paid after the close of the year, but on or before two and one-half months following such close, the corporation may elect to treat all or a portion of the amount as paid during the year. (57-228). Traveling expenses incurred in connection with the performance of official duties as an uncompensated officer and member of a veterans organization are deductible. (57-327). Also deductible are lump-sum contributions to an agent appointed by a group of exempt national health organizations engaged in a joint campaign for soliciting donations. (57-487). But the value of newspaper space donated by a newspaper to a charitable organization does not qualify as a contribution since the newspaper is not donating property but is merely rendering a service. (57-462). Neither is a deduction allowed for contributions to an individual to finance the publication and free distribution of a church directory to local hotels, motels, and tourist homes, because the donee is not in the classification of a corporation, trust, or foundation. (57-525).

Exempt Organizations

To secure tax exemption it is not sufficient that the profits inure to a public body but the organization itself must operate for charitable or similar purposes. (57-52). Where a corporation was organized to build a stadium for a school district with no profit to the stockholders, it is held exempt as an organization operated exclusively for the promotion of social welfare. (57-493). Even though an organization may be tax exempt as a medical and scientific research foundation, it will be taxed on income from the operation of a medical illustration department and electroencephalographic clinic conducted in a commercial manner, should the income from such operations be disproportionate when compared with the size and extent of the exempt activities. (57-313). A tax-exempt agricultural organization will also be held subject to tax on the income resulting from resale of supplies and equipment to its members. (57-466).

The fact that an organization operates on a non-profit basis is not the sole criterion for granting tax exemption. Tax-exempt status as a business league has been denied a non-profit organization which publishes the works of its members in anthologies and also makes contractual arrangements for radio and television programs based on such works. (57-453). Also, a home for aged people, run on a non-profit basis, which does not accept charity guests and which requires the discharge of guests who fail to make certain required monthly payments is held not entitled to tax exemption as an organization operated exclusively for charitable purposes. (57-467). On the other hand, the Service holds a non-profit organization maintaining a two-way radio system for its members on a mutual cost-sharing basis, exempt under Section 501 (c) (12) as being "like" a mutual or cooperative telephone company, provided 85 per cent or more of its income is derived from members for the sole purpose of meeting losses and expenses. (57-429). It also holds a corporation organized for the purpose of rehabilitating unemployed persons over a stated

age through public education, entitled to tax exemption as an organization operated exclusively for the promotion of social welfare. (57-297). But, should a voluntary employees' beneficiary association fail to qualify for exemption under Section 501 (c) (9) because 85 per cent of its income does not consist of amounts collected from members or of contributions by the employer, it cannot then qualify for exemption as a social welfare organization under Section 501(c)(4). (57-494).

Prizes, Scholarships and Awards

An award by a charitable foundation to a distinguished teacher is nontaxable where made solely in recognition of past educational achievements. (57-19). However, should the award be made as a supplement to the faculty member's salary, the award would be taxable to the recipient even though paid from funds specifically donated to the educational institute for that purpose. (57-460). An individual may, of course, avoid tax on a prize or award by refusing to accept it. (57-374).

The Service now concedes that Guggenheim and similar grants were nontaxable under the 1939 Code. (57-286). The portion of a fellowship grant for the academic year 1953-54 received in 1953 as a part of a Rockefeller Public Service Award in recognition of outstanding service by a civilian governmental employee constitutes an excludable gift under the 1939 Code. That portion of the award received in 1954 is subject to the exclusion limitations of $300 a month for a maximum of 36 months. (57-50).

Stipends received by interns and resident doctors performing services at a medical training hospital are compensation and not scholarships. (57-386). Similarly, amounts received from a hospital by a student enrolled as a candidate for a master's degree in hospital administration who is required to serve as an "administrative resident" are not exempt. (57-385). But awards received by degree students and others taking advanced courses of training for professional nurses at certain universities under the Public Service program are considered scholarship or fellowship grants. (57-370). Should a nonresident alien be granted allowances by an exempt foundation for the purpose of aiding him in the pursuit of study or research in the U. S. as an exchange fellow, the allowances are excludable from gross income subject to the scholarship and fellowship grant limitations. (57-131). All amounts received by students of a theological seminary from a parish during the year they are required to serve as part-time or assistant pastors of the parish, constitute compensation and cannot be treated as scholarship or fellowship grants. (57-522).

What is Income?

Repayment by a tax consultant to a taxpayer of an overpayment of tax as recompense for an error made in the preparation of his return is nontaxable. Any recovery of the consultant's fee or of interest on the overpayment would be taxable. (57-47). Members of a reserve component receiving lump-sum "readjustment payments" must include such sum as taxable compensation. (57-164). Strike benefit payments paid by a labor union as a result of a strike, constitute income to the recipients even though distributed on the basis of need, and regardless of whether the recipients are union members. (57-1). However, blind persons would not be taxable on welfare benefits received under state law. (57-102). Interest on dividends accumulated by the Veterans' Administration on a converted U. S. Government life insurance policy, or on a National Service life insurance policy, is

not a tax-exempt veteran's benefit, and is subject to tax. (57-441).

Where an individual received a specific bequest which the will stipulated was to include all compensation for her services as executrix, and the right to the sum was not contingent upon her performing any duties, the bequest is not to be treated as taxable compensation. (57-398).

The mere designation by a state of a portion of the compensation paid police officers as a "subsistence allowance" will not serve to exclude such amount from income within the meaning of Code Section 120 since the statutory allowance must be authorized for meals and other incidental expenses in connection with a police officer's duties. (57-46). A sanitation or building inspector cannot be considered a police official for purposes of this subsistence allowance exclusion. (57-309).

Voluntary pro-rata payments by shareholders to their corporation may represent contributions to capital. However, that portion of annual membership dues received by a taxable organization which is allocated to a special reserve fund to pay interest and principal on a mortgage, cannot be excluded from the corporate gross income since the payment of dues is not a voluntary contribution. (57-375). Should a corporation distribute agricultural products as a dividend in kind, the excess of the fair market value of the products over their cost is not includible in the corporation's gross income although an adjustment must be made effecting the removal of the assets from opening inventory and subsequent cost records. (57-490). A reserve for bad debts which had accumulated by additions for which a corporation derived full tax benefits in prior years, constitutes ordinary income to the corporation in the year it completely liquidates. (57-482).

Head of Household

The "right to exercise family control" test is not applicable for head of household. Thus, where an individual contributed more than half the cost of maintaining the household where he and his father, stepmother, half-brother and half-sister reside, and only the half-brother and half-sister qualify as dependents, he is entitled to compute his tax as a head of household. (57-415). But a taxpayer who maintains his mother in a home for elderly women is denied the status because he is not "maintaining a household" for her. (57-307).

Dependents

A trainee-employee attending classes at an educational institute owned and operated by a large industrial corporation and various associated employers, having a permanent faculty, a regularly organized body of student-employees in attendance, and offering credits recognized by and transferable to other institutions of higher learning, may qualify as a full-time student for purposes of the dependency exemption. Any travel expenses he incurs between the institute and the individual's place of employment are nondeductible personal expenses, while amounts received by him from his participating employer while in training constitute taxable compensation rather than nontaxable scholarship or fellowship grants. (57-484). To determine the amount of support furnished, social security benefits paid on behalf of a surviving child of a deceased worker and used for the child's support must be considered as the child's contribution toward his own support. (57-344).

Alimony

The Service now holds that an individual and his spouse who are separated

under an interlocutory decree of divorce retain the relationship of husband and wife until the decree becomes final, and may, under the 1939 and 1954 Codes, file a joint return. However, pursuant to the 1954 Code, where the husband and the wife live apart and file separate returns, payments to the wife during the period covered by the interlocutory decree may constitute periodic alimony payments. (57-368). Life insurance premiums paid for the benefit of a divorced wife on policies not assigned to her, pursuant to a property settlement which becomes part of the divorce decree, do not qualify as periodic alimony payments because the wife is only a contingent beneficiary. (57-125). Where a husband received a Mexican divorce and his wife was later awarded alimony "pendente lite" pursuant to a court decree in a state which does not recognize the validity of the Mexican divorce, the fact that the Mexican divorce preceded the award does not preclude its deductibility as alimony. (57-113). No taxable income is realized by a husband in setting up appreciated stock in trust for the benefit of his divorced wife. (57-506). But where a husband has a definite obligation to his wife under a separation agreement, a transfer of appreciated property to an irrevocable trust for the wife's benefit will result in taxable income being realized. (57-507).

Medical Expenses

A taxpayer claimed medical expenses for himself and his second wife, both under 65 years of age, and for his first wife over 65, who died during the taxable year. The Service holds that taxpayer and his second wife may deduct their medical expenses to the extent such expenses exceed 3 per cent of adjusted gross income. However, the medical expenses of the first wife are not subject to the 3 per cent limitation since she reached 65 during the taxable year. The overall deduction is limited to the maximum amount based upon two exemptions. (57-310). Amounts paid by a blind individual for food, innoculations, and other expenses connected with the maintenance of a "seeing-eye" dog used daily in the conduct of his business, are classified as medical expenses (subject to the percentage-of-income and maximum limitations), and are not in any event deductible as business expenses. (57-461). A taxpayer whose wife is a bed patient at home and requires constant attention of a nurse, may deduct as a medical expense the social security taxes paid as employer on the nurse's wages. (57-489).

Deductions

The New Hampshire tobacco tax is deductible effective July 14, 1955. (57-486). Also, the Rhode Island tax on cigarettes evidenced by stamps affixed to the package is held to be a deductible retail sales tax (57-442), as is the Illinois use tax on personal property purchased at retail (57-433). The filing fee of three or five per cent of annual salary required by New Mexico from each candidate for election constitutes a deductible state tax. (57-345).

A corporate officer claiming a deduction for travel and entertainment expenses must prove that he is entitled to such deduction. The Service rules that the reimbursement from the employer, or a corporate resolution requiring the officer to assume such expenses, would tend to indicate that they are necessary expenses of his office. However, such evidence does not conclusively determine that the expenses are deductible, nor does the absence of such evidence preclude their deduction. (57-502). Payments by an employer for an executive rehabilitation plan under which executives can avail themselves of recondi-

tioning and health-restoring services afforded by certain resort hotels and athletic clubs, are compensatory in nature and as such are deductible by the employer and includible in the executive's gross income. (57-130). Where a business abandons all its assets including goodwill, the tax basis of the goodwill is deductible as an ordinary loss. (57-503).

Penalty payments to a mortgagee for the privilege of prepaying a mortgage indebtedness, are deductible as interest. (57-198). A painter's work clothes even though prescribed by his local union, is considered not distinctive in character nor in the nature of a uniform. The cost and maintenance of such clothing therefore represents nondeductible personal expense. (57-143). Representation expenses incurred by Foreign Service officers or employees reporting on a cash basis are deductible to the extent they exceed the reimbursment received during such year, even though the reimbursement relates to expenses of a previous year. (57-364). Damage to residential property, caused by the collapse of mine excavations beneath the surface property, results in a deductible casualty loss. (57-524).

The 50 per cent deduction of the excess of net long-term capital gain over net short-term capital loss does not constitute a deduction attributable to a trade or business for purposes of the limitation on business deductions allowable to individuals where such deductions for each of five successive years exceed gross business income by more than $50,000. (57-527).

Retirement Income

In computing the retirement income credit, the Code provides that retirement income is to be reduced by earned income in excess of, (a) $900 for taxpayers under 65, and (b) $1,200 for taxpayers between 65 and 72. In the case of doctors, dentists or other professional taxpayers who may have large investments in office equipment, capital is not an income-producing factor in the business, and accordingly the entire amount of their professional fees, without reduction for any expenses, is to be considered as "earned income" in the above computation. (57-141). A veteran over 65 must reduce the maximum retirement income of $1,200 by the excess of nontaxable monthly installments from a matured U. S. Government life insurance endowment contract received during the taxable year, over the proportion of such total amount which is attributable to the investment in the contract. (57-504). Sick pay, whether or not excluded under Section 105(d), also constitutes earned income for purposes of this reduction. (57-101).

Taxable income consisting of rents, dividends, and interest received from an estate by a beneficiary who has reached the age of 65, qualifies as retirement income. (57-277). Similarly, partnership income, or trust or estate income, reported by a partner or beneficiary which represents the distribution of rental income, constitutes retirement income. For purposes of reducing retirement income where personal services are a material factor in the production of rental income, the earned income element must be considered whether taxpayer is reporting rental income individually received or whether the rental income represents a distribution from a partnership. (57-351).

Tax-Free Exchanges

The recognition of gain upon sale of a residence may be postponed if the proceeds are used to acquire a new residence within one year, or are used to construct a residence within 18 months. Where a taxpayer purchased a partially constructed new residence

within a year of the sale of his old, the new residence must be completed within the year to obtain nonrecognition-of-gain privileges. He cannot rely on the 18-month rule because he has not engaged in construction "commenced by the taxpayer." (57-234). An exchange of lots among three individuals who had acquired the lots to construct homes thereon, but later abandoned their plans and continued to hold them for investment purposes, is considered a nontaxable exchange of like-investment property. (57-244). Farm land belonging to an incompetent "exchanged" for another tract of farm land by means of a technical sale and purchase, because state law does not permit the guardian to *exchange* his ward's property for like property, will still be treated as an exchange of like properties for purposes of nonrecognition of gain. (57-469).

Involuntary Conversions

Condemnation under Code Section 1033 means the taking of private property for public use upon payment. The sale of an apartment house after it was declared unfit for habitation under local law unless extensive repairs were made, is not a threat of condemnation permitting nonrecognition of gain on conversion. (57-314). Nor does the sale of a golf course which had lost its value when bisected by a state highway qualify for treatment as an involuntary conversion. (57-117). The exercise of a purchase option in a three-year lease by a city under threat by the city of condemnation, constitutes an involuntary conversion, but the rental paid under the lease is taxable as ordinary income, not constituting part of the proceeds from the involuntary conversion. (57-261). Where a taxpayer sold its property to a city under threat or imminence of condemnation and then leased back the property for the period prior to its use by the city, the lease-back will not disqualify such sale as an involuntary conversion. (57-70). Although a farm involuntarily converted may be replaced with an interest in another farm as a tenant in common, the purchase of an interest in a partnership owning such a farm will not qualify as property similar to that converted. (57-154).

The acquisition by tenants in common of converted property, of 85 per cent of the stock of a corporation owning similar property, qualifies as a tax-free replacement since the tenancy, as a single unit, was maintained for the acquisition. (57-408). But the investment of condemnation proceeds by twc corporations with identical stock ownership in stock of a new corporation owning similar property does not qualify as a proper replacement because each corporation's purchase of the new stock does not constitute the acquisition of "80 per cent stock" control. (57-454).

Accounting Basis

An additional state income tax assessment accrues as a tax deduction to an accrual basis taxpayer when the amount is finally determined by litigation or default, or when the taxpayer acknowledges his liability for the amount of the increase. (57-105). Where claims are contingent rather than actual, an expense accrual for anticipated payments of personal injury claims pending at the end of the year is not deductible. (57-485).

Publishers who have consistently reported income and expenses on a deferred basis may now deduct circulation expenditures currently (57-87), even though such expenditures are reflected on the books and financial statements as deferred expenses. (57-526).

Amounts withheld and credited by banks and finance companies as "deal-

ers reserves" to cover possible losses on notes purchased from automobile dealers, constitute income to dealers on the accrual basis at the time such credits are made. Losses sustained on worthless notes are to be separately established. (57-2). The $5,000 death benefit exclusion cannot be prorated over the period during which monthly installments of a death benefit in excess of $5,000 will be paid. Rather, the entire amount of each installment must be excluded until an amount not in excess of $5,000 has been received, after which time all benefits received are taxable in full. (57-483). Non-interest "Growth Savings Certificates" issued by banks at a discount which increase in value at stated intervals are taxed in the same manner as Series E savings bonds. (57-452). An executory contract to buy or sell securities "when, as, and if issued" which cost the taxpayer nothing, has a basis of zero for tax purposes. (57-29).

Accounting Period

A calendar year taxpayer on the accrual basis created a revocable trust on a fiscal year basis using the cash method of accounting. Since the grantor's power to revoke made the trust income taxable to him, the method and period of accounting used by the trust is to be disregarded and the trust income is taxable to the grantor as if the trust had not been created. (57-390).

Where an individual is an employee for part of the year and operates as a business proprietor for the balance of the year, he must include in income not only his earnings as an employee, but all the business operations to December 31. If he desires to change his accounting period, he must first obtain the prior approval of the Commissioner. (57-389).

Depreciation and Amortization

With respect to new or used property acquired prior to January 1, 1954, and used property acquired after December 31, 1953, use of the 150 per cent declining-balance method of computing depreciation may be used: (1) by a new taxable entity in an initial return; (2) where permission to use such method has been granted by the Commissioner; (3) where the method is elected in the first return in which depreciation is sustained; (4) for taxable years after December 31, 1953, where the method is elected in the first year in which the property is subject to depreciation, regardless of the methods employed for the other depreciable property. (57-352). For such property, a change from the declining-balance method of computing depreciation to the applicable straight-line rate cannot be made without the Commissioner's consent. (57-510). Use of the new accelerated depreciation methods provided for in the 1954 Code is limited to the first user of property acquired after December 31, 1953. Should new replacement property be acquired after 1953 with the proceeds of an involuntary conversion of similar property in use prior to 1954, the new depreciation methods are applicable. (57-443).

Where stock ownership in a lessee corporation by the lessor and/or his family makes it reasonably certain that a lease can be renewed beyond its stated term, the cost of permanent improvements made by the lessee should be depreciated over their useful lives rather than the lease term. (57-361). The construction cost of a mausoleum is recoverable through crypt sales rather than through depreciation. (57-376). A finder's fee or buying commission paid by a bank to a third party for introducing a prospective mortgagor is to be capitalized over the life of the mortgage.

However, where a bank has already deducted the full commission in a year barred by the statute of limitations, it may not again deduct a prorata part of the same commission in a subsequent year. (57-100).

Capital Gain v. Ordinary Income

Transferable goodwill does not attach to the business of a professional man or firm although the courts have recognized that vendible goodwill may attach to a particular firm name. The Service therefore holds that none of the proceeds of a sale of a professional business, without a valid assignment of the right to the exclusive use of the firm name, may be treated as the proceeds from the sale of goodwill. (57-480). A five-year lease providing for the installation of an automatic fire protection sprinkler system in a warehouse and office building, and calling for "rental" payments over the lease period aggregating the cost of the system and its installation, constitutes a contract of conditional sale rather than a true lease. (57-371). Real estate acquired by a bank upon foreclosure of mortgages is considered property held for sale to customers in the ordinary course of its business where the properties are sold as soon as possible either in single parcels or subdivided, and the activities with respect thereto are substantial. (57-468).

Refund Claims

A delinquent form 1040 filed within three years of the original due date constitutes a proper refund claim. (57-354). A valid claim for refund may also be made on an amended form 1041 in the case of an estate or trust, and on an amended form 1120 in the case of a corporation. (57-501).

Sick Pay

Wages for a period of absence from work because of illness may qualify as excludable sick pay even though part of the illness period is reflected on the employer's records as vacation leave. However, the privilege to use vacation leave as additional sick leave must be provided for in the plan, or constitute an established custom of the employer. (57-384). A teacher who performs services during a nine-month school term and who is paid an annual salary in twelve equal monthly payments is not entitled to a sick pay exclusion for any part of a vacation period, even though he is incapacitated by a personal injury or sickness and receives a part of his salary during such period. The sick pay exclusion, where permissible, is to be computed on the basis of the working days during the school term. (57-360). Should an employee be receiving a disability pension while absent from work, he may exclude the pension as sick pay even though he is in a gainful occupation as a self-employed individual, or as an employee of another employer. Such additional activities will of course be considered in determining whether his absence from work was due to illness. (57-178).

Significant Federal Tax Decisions of 1957

By HERBERT M. MANDELL, C.P.A.

Federal Income, Estate and Gift taxes are the subject of litigation before the Tax Court, various District Courts, the Court of Claims, eleven Circuit Courts of Appeals, and the Supreme Court of the United States. During the thirteen months through November 1957, which is the period covered by this review, over 2,000 tax cases were handed down by these various courts. Obviously, this article, which must of necessity be limited in scope, can only touch on a few representative cases which are meaningful to the practicing accountant.

The selection of noteworthy tax decisions was based on many considerations. Of prime importance was whether the case was significant to certified public accountants in their tax practice. If so, does the case introduce a new principle of law? Those cases that reiterate established principles followed by the courts over the years were not considered sufficiently important for discussion. Where cases relate to the prior law, they were not reviewed, unless the principle involved is subject to similar treatment under the 1954 Code.

Most of the decisions of the United States Supreme Court involving tax matters were included as they are usually extremely significant. Furthermore, where the Supreme Court has agreed to review the decision of a lower court, these matters were for the most part deemed to merit examination.

The decisions have been arranged alphabetically under subject headings. The cases, therefore, are not listed in order of their importance.

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Accounting Methods

Under the Internal Revenue Code the Commissioner may prescribe a method of accounting for the taxpayer if his method does not clearly reflect taxable income. Often, there are many divergencies between the computation of income for tax purposes and income determined by the application of sound accounting principles.

In *Automobile Club of Michigan* v. *Commissioner,* 353 U.S. 180, affirming C.A. 6, 230 F. (2d) 585, (4/22/57, rehearing denied), the Supreme Court held that the Commissioner is vested with discretion under the Code to determine whether the taxpayer's method of accounting clearly reflects taxable income. The Commissioner did not abuse

his discretion in denying the taxpayer a pro rata allocation of automobile club membership dues received one year in advance, under the accrual method of accounting. The taxpayer was required to report the income in the year received because he had a claim of right without restriction as to its disposition.

Subsequent Tax Court cases have cited this case in holding that amounts received in advance on television service contracts and rentals by accrual basis taxpayers are income in the year of receipt where held under a claim of right without restriction as to disposition.

In the case of *Jay A. Williams and Ellen G. Williams*, 28 T.C. No. 114 (8/20/57), the Tax Court held that a promissory note received as security or as evidence of indebtedness and not as payment is not income at the time of the receipt. The Court stated that even if the promissory note was intended as payment, since it was unsecured, non-interest bearing and without fair market value, it would not be held to constitute income in the year of receipt.

The taxpayer in this case was in the business of locating timberland for prospective purchasers. He reported his income on the cash basis and received for his services in 1951 an unsecured non-interest bearing note payable in 240 days. At the time of issuance, the maker was unable to pay for lack of funds. It was further understood that the payor would be unable to pay the notes until he sold part of the timber which the taxpayer had located. Upon receipt of the note in 1951, taxpayer attempted on many occasions to sell the note to various banks or finance firms but did not succeed. In 1954, taxpayer received the money in discharge of the note. The Tax Court sustained the taxpayer who did not report any income until 1954 when he received payment of the note.

Accumulated Earnings Tax

A penalty tax, under Section 531 of the Code, is imposed upon a corporation if it accumulates income beyond the reasonable needs of its business. However, defining "the reasonable needs of the business" has been a perplexing problem for the practitioner.

The Fourth Circuit Court of Appeals in *Smoot Sand and Gravel Corp.* v. *Commissioner*, 241 F.(2d) 197, affirming in part and reversing in part T.C. Memo. 1956-82 (C.A. 4, 3/8/57 cert. denied) has helped to clarify several problems on this subject. It upheld the Tax Court on some points and reversed it on two points, sending the case back for reconsideration. The Court cited the *J. L. Goodman Furniture Co.* case, 11 T.C. 530 (1948), in determining the amount of required working capital in a business. In that case, the Tax Court held that "accumulation of funds to meet operation expenses for at least one year is reasonable." However, the Fourth Circuit stated that in applying this formula, operating expenses should be expanded to cover direct expenses included in cost of goods sold, such as wages, fuel and supplies. Therefore, the Court held that a corporation may accumulate earnings in an amount to cover one year's operating expenses including direct expenses under cost of goods sold. The Court further held that other factors must be considered such as the company's credit policies, the amounts of inventories and its rate of turnover, the amount of accounts receivable and the collection rate thereof, and the availability of credit to the business.

The Tax Court was reversed on a second point in this case. The company had set up a reserve to cover the possibility that it might have to enter the ready-mix cement business in order to meet competition. The Tax Court had held that the company never planned or intended to go into this expansion pro-

gram of its own free will. The Circuit Court held that the fact that the expansion would not be voluntary is unimportant. If it might be reasonable to anticipate the need for expansion, then the corporation was justified in setting up the reserve.

The 1954 Code introduced a new provision which suggested that the burden of proof might be shifted to the Commissioner to establish that earnings are accumulated beyond the reasonable needs of the business. However, *Pelton Steel Casting Co.,* 28 T.C. No. 20 (4/25/57), held that Congress did not intend to alter the taxpayer's burden of proving that income was not accumulated for the purpose of preventing the imposition of tax upon its shareholders. In this case, the petitioner retained earnings under a plan to purchase the interest of its major shareholder, and in compliance with the Code submitted a statement to this effect in answer to the Commissioner's notice of deficiency. The Tax Court held that this statement was not sufficient to sustain petitioner's stand that the accumulation was not for the avoidance of tax on its shareholders. The Court said that the purchase and retirement by the taxpayer of its outstanding stock was inconsistent with a business need of its own, but rather suited the personal or business needs of its shareholders.

Acquisitions to Avoid Tax

The long-established principle of *Alprosa Watch Co.* that a corporation, regardless of change of stock ownership, may use its own deductions, credits or allowance, has been questioned by a decision of the Fourth Circuit Court of Appeals. This principle had, of course, been modified to a great extent by Sections 382 and 1551 of the 1954 Code.

In *Coastal Oil Storage Co.* v. *Commissioner,* 242 F. (2d) 396, affirming in part and reversing in part 25 T.C. 1304 (C.A. 4, 3/11/57 non-acq.), a corporation transferred property to a newly organized subsidiary. The Commissioner disallowed the $25,000 exemption from surtax on the ground that the principal purpose for the creation of the subsidiary and transfer of property was to obtain an exemption it would not otherwise have enjoyed. The taxpayer argued that Section 129, 1939 Code (Section 269, 1954 Code) did not apply because the surtax exemption belonged to the taxpayer from its inception and was not secured by virtue of the transfer of assets to it. The Court said that "while the exemption is claimed by the taxpayer, the sole benefit thereof would accrue to the parent corporation, the sole owner of the stock," and therefore the parent corporation indirectly secured the benefit of a second surtax exemption. If other courts follow the reasoning of this decision then the long standing doctrine of *Alprosa Watch,* 11 T.C. 240 (1948), may be changed. However, the recent decision of *T.V.D. Company,* 27 T.C. No. 108 (2/28/57), follows *Alprosa Watch* where it held that under the 1939 Code a taxpayer is entitled to use its own deductions and credits even though there is a change in the nature of the business as well as a change in stock ownership. The persons who acquired control of the corporation did not themselves directly obtain the tax benefit. If the *Coastal Oil* reasoning is followed then the use by a corporation of its own loss carryover against future profits under certain circumstances may be precluded by this decision that new stockholders are indirectly securing the benefit of the loss deduction and therefore Section 269 applies to such acquisition.

In *American Pipe and Steel Corp.,* 243 F. (2d) 125, affirming 25 T.C. 351 (4/17/57 cert. applied for), the Commissioner successfully used for the first

time Section 129, 1939 Code, (Section 269, 1954 Code), in preventing the use of a consolidated return to offset losses of the acquired corporation against the profits of the acquiring corporation. The taxpayer was a corporation engaged in the steel fabricating business. It acquired the stock of a real estate corporation which held residential lots with a high tax basis but a low market value. After acquiring the capital stock, the subsidiary sold the lots, sustaining substantial losses. The corporation filed consolidated returns and the losses of the subsidiary were offset against the profits of the parent company. The Commissioner was sustained by the Courts in applying Section 129, 1939 Code, on the grounds that the principal purpose of the acquisition was tax avoidance. The taxpayer claimed that the acquisition of a real estate company improved its position in the sale of pipe and casing in real estate developments. The Court pointed out that at a total cost of $11,000 the corporation acquired tax losses of $400,000 and that any new corporation formed in the real estate field could have satisfied the requirement of the taxpayer. The Court further stated that within two months after acquisition, the subsidiary was a mere corporate shell.

Bad Debt Losses

For many years, the Commissioner and various courts had disagreed on the treatment of losses sustained in guaranteeing indebtedness of a primary debtor. Some courts held that a guarantee loss is an ordinary deduction, while the Commissioner and the Tax Court held them to be subject to the special provisions relating to debt losses. If it is a non-business bad debt, it is deductible as a short-term capital loss, subject to the limitations of capital loss deductions.

In *Max Putnam and Elizabeth Putnam* v. *Commissioner*, 352 U.S. 82, affirming C.A. 8, 224 Fed. (2d) 947, (12/3/56), the U.S. Supreme Court said, "there is no real or economic difference between the loss of an investment made in the form of a direct loan to a corporation and one made indirectly in the form of a guaranteed bank loan. The tax consequences should in all reason be the same." In coming to this conclusion, the Court used the rule that the payment by the guarantor of the debt makes the debtor's obligation to the creditor an obligation to the guarantor. Thus, the loss sustained by the guarantor, unable to recover from the debtor, is by its very nature a loss from the worthlessness of a debt.

In this case an attorney undertook a venture, not connected with his practice, to organize the publishing of a labor newspaper. The taxpayer as a stockholder guaranteed the obligations of the corporation. Upon liquidation, the funds of the corporation were insufficient to pay some of the debts guaranteed. Petitioner paid these debts and attempted to claim the loss as an advisory business loss, or a loss sustained during the taxable year not compensated for by insurance or otherwise. The Court held that this was a non-business bad debt loss subject to short-term capital loss treatment.

Business Expenses

Courts have consistently held that fines paid for violation of State statutes are not deductible as business expenses on the theory that such an allowance would frustrate State authority. Apparently, this is held to be so whether the violation was a wilful breach or an innocent mistake. In *Tank Truck Rentals, Inc.* v. *Commissioner*, 242 F. (2d) 14, affirming 26 T.C. 427, (C.A. 3, 3/6/57, cert. granted), the Court of Appeals held that overloading fines paid

by a motor carrier were not deductible, notwithstanding taxpayer's contention that it would have been at a competitive disadvantage if it had attempted to conform to State laws. It was pointed out that it was the general practice of the trucking industry to overload even at the risk of incurring fines. The court stated that certain expenditures otherwise ordinary and necessary are not deductible, if their allowance would frustrate sharply defined national and state policies. It is not the federal court's duty in a tax controversy to inquire into the wisdom of a state motor vehicle statute and its state enforcement policies.

In a prior motor carrier case, *Hoover Motor Express Co., Inc.* v. *United States*, 241 F.(2d)459 (C.A. 6, 1/4/57, cert. granted), the Sixth Circuit also held that overloading fines are not deductible as business expenses. It should be noted that although both Circuits are in agreement, the Supreme Court has granted certiorari in both decisions.

In *Cotton States Fertilizer Company* v. *Commissioner*, 28 T.C. No. 138 (9/16/57), two of the taxpayer's plants were destroyed by fire. Using a contractor's estimate which was based on an architect's plans and specifications, the taxpayer recovered insurance proceeds exceeding the adjusted basis of the plants. The actual cost of replacing the destroyed plants exceeded the insurance proceeds and the taxpayer, pursuant to his election under the Code's involuntary conversion provisions, reported no gain on receipt of the proceeds. The taxpayer however deducted the fees paid to the contractor and architect as ordinary business expenses. The Commissioner disallowed the deduction on the ground that the nonrecognized gain was wholly exempt income and any expenses attributable thereto were non-deductible. The Court held, however, that the insurance proceeds did not constitute wholly exempt income since the taxpayer was required to decrease the basis of the new property by the amount of the gain not recognized as a result of his election, and the gain would eventually be taxed in a subsequent sale of the property. Therefore, the expenditures incurred in obtaining the insurance proceeds were held to be deductible.

Casualty Losses

An interesting case dealing with casualty losses was presented in *The Citizens Bank of Weston*, 28 T.C. No. 79 (6/26/57, appeal pending). In this case the taxpayer, a bank, had stored records in the basement of its own building. A flash flood inundated the basement destroying the records. Fearing similar floods, the taxpayer gave up using the basement but continued using the rest of the building which was not damaged in any way. The taxpayer deducted $76,000 as the alleged decline in the fair market value of the building as a result of the flood.

The Court held the taxpayer had not shown any loss as it had continued to use the building which was not physically damaged as a result of the flood. The taxpayer had conceded that if a flood-control program were adopted the basement would be usable. Furthermore, the taxpayer did not establish permanent abandonment of the basement. Mere non-use of property was not considered abandonment under the statute.

Another unusual case was *Katherine B. Bliss*, 27 T.C. No. 93 (2/13/57, appeal pending), where the Tax Court held that a taxpayer who had a life estate interest in a residence and farm was entitled to a casualty loss deduction. The loss was apportioned

between the life tenant and the remainder interests, using the tables prescribed in the Regulations.

Collapsible Corporations

There have only been six Tax Court cases interpreting the original collapsible corporation statute since it became part of the Internal Revenue Code on January 1, 1950. The first two cases decided in 1956, were won by the taxpayers, where the burden of proof was on the government, since the applicability of the *collapsible* statute was not claimed in the government's original deficiency notice. However, in 1957, all four Tax Court decisions were adverse to the taxpayers where they had to sustain their usual burden of proof. In *Raymond Burge,* 28 T.C. No. 26 (4/30/57, appeal pending), the Court held that the *collapsible* statute applied to distributions of cash from an F.H.A. insured mortgage loan in excess of the cost of construction. The decision clearly stated that the statutory language applies not only to temporary corporations but also to corporations that continue in existence, if the gain is realized at the stockholder level rather than by the corporation. In this case as well as the others, the Tax Court found that the taxpayer did not sustain his burden of proof to show that there was never any intent to avoid the corporation's fair share of tax.

In *J. D. Abbott,* 28 T.C. No. 89, (6/28/57, appeal pending), the taxpayer contended that the corporation never engaged in construction but only installed streets, utilities and sewers and arranged F.H.A. financing. The corporation was dissolved after these preliminary activities and the stockholders sold the land to others who constructed the buildings. The Court held that the activities in improving the land were the first step in construction.

In the cases of *Edward Weil,* 28 T.C. No. 90 (6/28/57), and *Arthur Glickman,* T.C. Memo 1957-124 (6/28/57), the taxpayers argued that the construction had been completed and then unforeseen events occurred which made it necessary for them to sell their stock. There is little question under both the old and new Regulations that if the property is sold during the period of construction, the *collapsible* statute would apply. However, if it can be shown that during the period of construction the stockholders never had any intent to sell their stock or receive a distribution from the corporation, the statute might not be applicable. It must also be shown that the circumstances which made it desirable to sell could not have been reasonably anticipated and did not originate until after construction was completed. The problem of when the construction is considered complete was reviewed in these cases. The Court decided that construction is complete within the meaning of the Statute only when the property is in shape to begin to realize net income. Substantial completion is not sufficient. Issuance of a Certificate of Occupancy is not controlling, whereas full occupancy with completion of all details, including landscaping, are indications of the final date of completion. Under the facts presented in both of these cases, the date of construction was held by the Court to be a date after the collapsible intent arose, and therefore the Statute applied.

Problems of the Closely Held Corporation

Stockholders of closely held corporations and their tax advisers will long remember the year 1957. After the adverse tax court decisions in *Casale, Prunier, Holsey,* and *Sanders,* it appeared that it would be difficult for the closely held corporation to engage in construc-

tive tax planning for perpetuating its existence upon the death of one or more of its major stockholders. However, the reversal of the *Prunier* and *Casale* cases by the First and Second Circuit Courts of Appeals in the fall of the year gave considerable comfort to tax practitioners by removing many uncertainties in this area.

The case of *Oreste Casale* v. *Commissioner*, 247 F. (2d) 440, reversing 26 T.C. No. 131, (C.A. 2, 9/5/57), involved a closely held corporation where the principal stockholder owned 98 per cent of the outstanding stock. The corporation entered into a contract with Casale whereby it obligated itself to pay Casale at the age of 65 a monthly retirement income. If he should die before that date a certain sum was to be paid to his designee.

At the same time the corporation purchased a life insurance policy whose terms tied in with the retirement income benefits payable by it under the deferred compensation agreement. The corporation was the owner of the policy, had the right to change the beneficiary, the right to borrow against it and all other rights consistent with ownership.

Based upon the above facts, the Treasury Department contended that Casale received a taxable dividend in that the premiums paid for the year bestowed upon him an ascertainable economic benefit. It also contended that the entire transaction was a sham and in effect no more than a device whereby Casale purchased a retirement annuity for himself with corporate funds. The Tax Court supported the Treasury's viewpoint in holding that the corporation was no more than the alter ego of Casale.

The Second Circuit, in reversing the lower court decision, disagreed sharply with the Tax Court conclusion that the corporate entity was to be disregarded. It rejected the finding of "sham" which was based upon the fact that Casale could direct the activities of the corporation and by so doing vote himself this retirement income. The Second Circuit emphasized the point that the creditors rights were superior to that of Casale in the event of an insolvency and the insurance was subject to the claims of outside creditors. Finally, it held that the mere purchase by the corporation of a policy resulted in no immediate personal benefit to a stockholder and concluded that the corporate entity cannot be disregarded even though it is a closely held company.

There is no doubt but that the Second Circuit's reversal of *Casale* had a substantial influence upon the First Circuit Court of Appeals when the latter court reviewed the *Prunier* case. This case, *Henry E. Prunier and Winifred Prunier*, F. (2d) reversing 28 T.C. No. 4, (C.A. 1, 11/8/57), can best be cited as 'the case where the taxpayer did everything wrong.' The Tax Court originally held that premiums paid by the corporation on certain policies, which were to be used to pay out his estate, were taxable dividends to the stockholders in the year in which the premium payments were made. Here, two brothers each owned approximately half of the stock of the corporation. The brothers, however, and not the corporation, were named as criss-cross beneficiaries of the policies. The policies were owned by the brothers with the right reserved by them to change the beneficiaries. There was an agreement between them, cited in the corporate minutes, which provided that upon the death of either of them, the proceeds of the policies were to go to the corporation to be used to buy out the interest of the deceased. The corporation, however, was not a party to the agreement.

The Tax Court holding in *Prunier* following closely upon *Casale* had created great uncertainty. In many quarters it was felt that these cases held that premiums paid by a corporation on in-

surance on the lives of its stockholders, where the proceeds were to be used by the corporation to acquire the deceased's stock, constituted taxable income to the stockholders. Moreover it was thought by some that the surviving stockholder would receive an ordinary dividend when the interest of a deceased stockholder was purchased through the use of insurance proceeds.

The First Circuit took the viewpoint that under Massachusetts law, the corporation would be the beneficiary of the policies and could acquire the deceased stockholder's stock with the proceeds. This unusual fact pattern therefore was not a vital defect. It saw no objection in the fact that the surviving stockholder would derive a benefit from the acquisition by the corporation of the deceased brother's stock. The Court felt that there was a real corporate business purpose, as distinguished from that of the individual stockholder, in the use of the life insurance proceeds to buy the deceased stockholder's interest in the company.

The case of *Robert V. Sanders* v. *Fox*, 149 F. Supp. 942, (D.C., Utah; 4/27/57), was similar to *Prunier* but differed in that there was a formal retirement agreement between the stockholders and the corporation whereby the insured stockholder designated his beneficiary. Here also, two of the four stockholders owned approximately 75 per cent of the stock. The corporation, however, was in fact designated as the owner of the policies with power to exercise all rights. However, by the terms of the agreement, it was possible for the individual's designee to receive insurance proceeds in excess of the fair value of the stock. On these facts the Court held that the individuals were receiving a benefit from the payment of premiums by the corporation and that the premiums should be taxed to the stockholders as dividends paid by the corporation. The taxpayers have appealed this case but as yet the Circuit Court of Appeals has not rendered its decision.

In *Joseph R. Holsey*, 28 T.C. No. 107 (8/8/57), the Tax Court held that the holder of 50 per cent of the outstanding stock of a corporation received an ordinary dividend when the corporation purchased the other 50 per cent from another stockholder pursuant to an option assigned by the remaining stockholder (i.e. *Holsey*) to the corporation. The taxpayer argued that he could not be charged with a dividend. He stated that the corporate payment to the other stockholder served a business purpose because the corporation was merely following policies laid down by the automobile manufacturer for whom the corporation was a franchised dealer. The Tax Court, however, held the test was whether there was any personal benefit to the stockholder, and it so found in this case. Clearly, the existence of the stock option agreement was of great importance in the Tax Court's rationale in arriving at a decision.

Depreciation

An unusual and important case dealing with depreciation of a building located on leased property was decided by the Tax Court in the case of *David Dab and Rose Dab*, 28 T.C. No. 103 (7/30/57, appeal pending), where the taxpayer depreciated a 99-year leasehold over a period of twenty years. The twenty years was an estimate of the remaining life of a building, located on the leased land, and erected in 1928 by a previous owner of the property. The lessee also had the right to terminate the lease at the end of the 25th, 50th and 75th year.

The Tax Court held that since the taxpayer did not erect the building, or own it, he had no depreciable interest in the building and therefore the 99-year leasehold was not depreciable over the

shorter estimated life of the building. The Tax Court also stated that the Regulations made no allowance for depreciation by the lessee of buildings and improvements existing on the land at the time the lease was consummated.

A distinction is made by the Court between the purchase of a leasehold with a building in existence in contrast to the leasing of land where the tenant constructs the building. In the latter case, the Regulations indicate that the tenant could depreciate the building over its useful life or amortize the cost of construction over the life of the lease, whichever period is shorter. However, where one amount is paid to acquire a leasehold, including an existing building, the Tax Court indicates that amortization may only be claimed over the life of the lease.

Another question raised in this case is whether the taxpayer should be allowed to depreciate or amortize its 99-year leasehold over a period of 25 years, its first opportunity to terminate under the lease. The taxpayer maintained that a lease for 99 years with options to terminate at the end of the 25th, 50th and 75th years is the same as a lease for a 25-year original term with stated rights to renew. The Court did not agree and held that a lease for 99 years with options to terminate is a lease for 99 years if no affirmative action is taken to terminate. The Court held that this lease is different from a lease for 25 years with options to renew for an additional 74 years. Therefore, the value of the leasehold was to be written off over the full life of the 99-year lease.

Individual Taxpayer Problems

An analysis of the large number of cases involving individual taxpayers indicates that the decisions usually are based on an interpretation of the facts presented, in the light of established principles of law. The following cases, however, were based on an interpretation of the law, rather than the particular facts involved, and therefore merit closer attention. In *F. C. Bowers*, 243 F. (2d) 904, reversing 25 T.C. No. 56 (C.A. 6, 4/26/57, cert. not authorized), the Court of Appeals reversed the Tax Court and allowed a deduction for a portion of the legal fees paid by a husband in divorce proceedings. The Court allowed the deduction as a cost of conserving income-producing property. The Tax Court has consistently held that legal expenses incurred by a husband in resisting financial demands made by his wife, incident to divorce proceedings, are non-deductible personal expenses. In this case, the lawyer's services were shown to be largely devoted to negotiating a settlement agreement under which the husband retained control over stock in a closely-held profitable corporation. The Court permitted a deduction for the portion of the fee allocated to such services.

In *Walter J. Hein*, 28 T.C. No. 92 (6/28/57, appeal pending), the taxpayer was allowed a head of household status even though his aged sister, whom he supported, was confined to a mental institution. The court viewed the absence of the dependent sister from the taxpayer's household as temporary, since that is where she would have returned if she ever recovered. The fact that she had little if any chance of recovering was not controlling.

The Government's interpretation of the limitation on the dividends received credit was overthrown in *Springs* v. *U. S.*, 153 F. Supp. 514 (D.C., S.C.; 8/5/57). This decision is contrary to the instructions for the individual tax return in current use, and should therefore be taken into consideration by those taxpayers affected. The credit for dividends received by individuals is limited to 4 per cent of "taxable income." The government contends that where the alterna-

tive tax on capital gains is applicable, the 4 per cent limitation should be based on the "taxable income reduced by" 50 per cent of capital gains. The Court held that the statute does not require the reduction in computing this limitation.

Sale of "In Oil" Payment Rights

The sale of oil payments carved out of royalty interests has been used as a tax device to convert ordinary income into capital gain. An oil payment generally is the right to receive a specified amount of royalty income or the right to receive a percentage of output for a limited period of time. It may also be applied to the output of various mineral products, other than oil. During 1957, cases were handed down by the Fifth and Seventh Courts of Appeals dealing with this subject. The Fifth Circuit held that the sale of oil and sulphur payments resulted in capital gain treatment and the Seventh Circuit held that an assignment of oil payment rights gave rise to ordinary income. As a result of this conflict and the importance of this entire area, the Supreme Court granted certiorari in several of these cases relating to the tax treatment of the sale of in-oil payment rights.

The Fifth Circuit, on February 1, 1957, handed down several significant decisions relating to carved out oil payment rights all of which held that the sale or exchange of such rights results in capital gains. In the case of *Scofield* v. *O'Connor*, 241 F. (2d) 65, affirming the District Court, 143 F. Supp. 240 (C.A. 5, 2/1/57, cert. granted), an estate assigned an oil payment and received approximately $9,900,000 for the assignment. The oil payment was to revert to the estate when the assignee collected $10,000,000. The taxpayer collected this amount in about three years. The Court found that the transfer was substantial and allowed capital gain treatment to the estate. The Court rejected the length of the pay out period as the test in determining whether there was a sale of property in contrast to an assignment of incomes. It held that a sale for $10,000,000 of oil payment rights was substantial and therefore entitled the taxpayer to capital gain treatment.

In *Lake Inc.* v. *Commissioner*, 241 F. (2d) 71, affirming 24 T.C. 1016 (C.A. 5, 2/1/57; cert. granted), the Court allowed capital gains treatment. The Court rejected the Commissioner's contention that a distinction should be drawn between oil payments carved out of a leasehold or working interest and payments carved out of a royalty or oil interest. It held that what was sold was the working interest which is a capital asset, and not the oil itself, which is an inventory asset. It also rejected his contention that the holding period of an oil payment started when the payment was carved out or created, but that the gain was long term because the working interest had been held for more than six months.

Wrather v. *Commissioner*, 241 F. (2d) 84, affirming T.C. Memo 1955-104 (C.A. 5, 2/1/57; cert. granted), and *Weed* v. *Commissioner*, 241 F. (2d) 69, affirming 24 T.C. 1025 (C.A. 5, 2/1/57; cert. granted), were cases decided by the Fifth Circuit on the same day and were based primarily on the authority of the two cases described above giving capital gain treatment to these transactions. A distinguishing feature of the *Weed* case was that it involved sulphur payments (instead of a dollar amount) which were to continue until 6 million tons of sulphur were received by the assignee. Distributions were made over a period of 28 months. The Seventh Circuit in *Commissioner* v. *A. J. Slagter*, 238 F.

(2d) 901, reversing 24 T.C. 935 (C.A. 7, 11/29/56), has held that the transfer of an oil payment was, in effect, an assignment of future income, rather than a sale of a capital asset where the taxpayer assigned a portion of oil and gas income until the assignee would receive a specified sum from the net proceeds. The Court makes an analogy in this case to the effect that the assignment of the income is similar to security for a loan. This brings up another important point. If this is similar to a loan, should the income be reported when the royalty income is paid to the assignee; or should the assignor report the income in a lump sum when he assigned the oil payment rights. The government contended that the assignor should report the amount received as a lump sum in the year of the assignment. The Seventh Circuit held that the assignor realized income only as the royalties were received by the assignee.

Tax Administration and Procedure

May a Commissioner's ruling be retroactively revoked where the taxpayer acts in good faith in reliance on the ruling? The Supreme Court, in *Automobile Club of Michigan* v. *Commissioner,* 353 U. S. 180 affirming 230 F. (2d) 585 (4/22/57; rehearing denied), held that the Commissioner is not estopped from retroactively revoking his 1934 and 1938 rulings exempting the taxpayer from income tax where such rulings were based on a mistake of law. The Court stated that the Code, contrary to the taxpayer's contention, does not forbid the Commissioner from taking retroactive action, but confirms the authority of the Commissioner to correct any ruling, regulation or Treasury Decision retroactively, and empowers him, in his discretion, to limit retroactive application when necessary to avoid inequities. The court found no basis for disagreement with the conclusion reached by both the Tax Court and the Court of Appeals that the Commissioner did not abuse his discretion in having dealt with the taxpayers upon the same basis as other automobile clubs. The Commissioner in 1945 notified the taxpayer that he had reconsidered its status in the light of a G.C.M. issued in 1943. The Michigan Automobile Club was then notified that it would be required to file tax returns, losing its exempt status retroactive to 1943. The taxpayer argued that the Commissioner could not, in the light of its previous rulings, require tax returns previous to 1945, when the tax exemption was revoked. The Supreme Court held that the Commissioner had authority to correct his mistake of law retroactive to 1943 in the light of the G.C.M. issued in that year indiscriminately to all automobile clubs. The two-year delay in these circumstances did not vitiate the Commissioner's action.

Transferee Liability

According to the Tax Court, a beneficiary of a life insurance policy may be liable, as a transferee, for taxes of the insured if the insured's estate was insolvent at the time of death, and the insured had the power to change the beneficiary. The Tax Court has held that the beneficiary would be liable to the extent of the entire proceeds of the life insurance. The Sixth Circuit Court of Appeals has held that if the insured was not insolvent at the time he designated the beneficiary, then the Government has no claim against the beneficiary. Other circuits have held that the beneficiary is liable as a transferee to the extent of the cash surrender value of the policy immediately prior to death.

In the case of *Mary Stoumen, et al.,* 27 T.C. No. 125 (3/28/57; appeal pending), the taxpayer retained the

right to change beneficiaries up to the time of his death and the payment of the insurance proceeds rendered the estate insolvent. The Government imposed transferee liability on the beneficiaries of the insurance to the full extent of the proceeds.

In *Jean F. Stern* v. *Commissioner*, 242 F. (2d) 332, reversing T.C. Memo 1956-23 (C.A. 6, 2/26/57); cert. filed), the Sixth Circuit Court of Appeals held that transferee liability will not be imposed on the beneficiary where his estate assets were insufficient to pay delinquent taxes. Decedent had retained the right to change the beneficiary and to draw the cash surrender value. The court stated that the government's claim for taxes is held subject to state law which held that the beneficiary of life insurance is entitled to the full proceeds of the policy as against the creditors of the insured.

The Tax Court in this case had said it would follow its own prior decisions in regard to transferee liability in spite of reversals by the Courts of Appeals. On reversal, the Sixth Circuit Court stated that the Tax Court like District Courts are bound to follow decisions pronounced by Circuit Courts of Appeals having jurisdiction over particular districts. The mere fact that it is a court having jurisdiction in the tax cases throughout the United States does not establish the Tax Court as superior in any aspect to the District Courts who are also bound to follow decisions of the Circuit Courts of Appeals. The Tax Court had said that since its jurisdiction is nationwide, it must apply its rules on a nationwide basis without limitation by the separate rules of the eleven different Circuit Courts.

The Seventh Circuit agrees with the Second Circuit in its reporting of *U.S.* v. *Nelle A. Hoper, et al.*, 242 F. (2d) 468, affirming in part, reversing in part, 144 F. Supp. 281 (D.C. 111) (C.A. 7, 3/20/57), where it held that a U.S. lien had superior rights to the extent of the cash surrender value of the policy. The Third Circuit similarly continues to hold that beneficiaries are transferees to the extent of the cash surrender value of the policies where the insured died insolvent. Its holding was such in *U.S.* v. *Molly G. Bess*, 243 F. (2d) 675, vacating 134 F. Supp. 467; (D.C.N.J.) (C.A. 3, (3/28/57); cert. filed), where it held that transferee liability is imposed on a wife as beneficiary of proceeds of decedent husband's insurance policies to the extent of its cash surrender value. Taxpayer under the circumstances had the right to change the beneficiary as well as the right to borrow upon the cash surrender value. At the time of issuance of the policies, the insured was solvent, but insolvent at time of his death.

The fact that the Supreme Court has granted certiorari in the above cases should eliminate the distinctions of the various courts in this area.

Traveling and Entertainment

During the year 1957, accountants have been harassed by a policy adopted by the Internal Revenue Service with respect to the treatment of unsubstantiated traveling and entertainment expenses of officer-stockholders of closely held companies. The Service has taken the stand that unsubstantiated expenses disallowed to a closely held corporation are also taxable to the individual officer-stockholders. During the year 1957, several cases were decided by the Tax Court on this subject. In several of these cases the Commissioner was sustained on the principle of imposing the double tax. In other cases, the Commissioner did not attempt to tax the disallowed expenses to the individual stockholders. In one case, a District Court allowed an unsubstantiated en-

tertaining allowance as a corporate deduction, treating it as additional compensation to the recipient on the theory that the total compensation, including the expense allowance, was reasonable.

The *Home Sales Co.*, T.C. Memo 1957-78 (5/17/57), is a case in point. Husband and wife were sole stockholders of a corporation. They and their two sons were the employees. The husband-stockholder was given $4,500 in a lump sum to reimburse him for expenditures made on behalf of the corporation for the year ended June 30, 1950. For the year ended June 30, 1951, his loan account was reduced by the amount of $4,500, again to reimburse him for expenses. The stockholder did not keep any records or receipts or other proof showing the nature or amounts of such alleged expenses as the amounts claimed were estimated figures.

The Tax Court found that the individual stockholder had expended some monies and allowed the corporation a deduction of $1,000 out of the $4,500 claimed, as ordinary and necessary business expense in each of the years involved.

The stockholder was found to have received additional income of $3,500 for 1950; his 1951 year was not involved for some unexplained reason.

It is interesting to note that the corporation did not attempt to claim the $3.500 as additional compensation because one of the other issues in the case was the reasonableness of compensation claimed by the corporation.

In *American Properties, Inc.*, 28 T.C. No. 127 (8/30/57), a case in a similar vein, the Court found that expenditures made in connection with the constructing, maintaining and operating racing boats did not constitute the carrying on of a trade or business but were incident to the personal hobby of its sole stockholder. The corporation therefore was not entitled to any deduction for these expenses or for depreciation on the boats. Furthermore, the sole shareholder was held to have taxable dividend income for the amount expended.

In *Alex Silverman*, 28 T.C. No. 121 (8/28/57; appeal pending), a minority stockholder was induced to go abroad by the corporation which offered to pay his bride's expenses on the trip. The Court found that the wife's expenses were non-deductible to the corporation as her presence served no business purpose. The individual was held to realize taxable income for these personal expenses. Silverman claimed that his bride's expenses were a wedding gift of the corporation, but the Court held that the necessary elements of a gift did not exist between the corporation and its employee-stockholder.

In *W. Horace Williams, Sr.* v. *U. S.*, 245 F. (2nd) 559, affirming —F. Supp. —(D.C. La.), (C.A. 5; 6/18/57), the taxpayer was suing for a refund of taxes. Under the facts of this case, the taxpayer was a 40 per cent stockholder of an engineering construction company. He received $42,000 a year as salary and $6,000 a year as an expense allowance which the corporation deducted as entertaining expense. The lower court had previously held that the corporation did not have a deduction for entertaining expenses as there was no substantiation of this item. It found, however, that the expense allowance was properly deductible as additional compensation because even when added to the $42,000 salary, the compensation was still reasonable and therefore deductible by the corporation as ordinary and necessary business expense. The Fifth Circuit denied the refund to Williams for lack of substantiation of expenses claimed. However, in the companion lower court case of the corporation, the government did not appeal the allowance of the $6,000 as a deduction for additional compensation.

Management Advisory Services—Opportunities and Limitations

By Max Block, C.P.A.

The Opportunities

It may be stated, justifiably, that all accounting services for business concerns constitute management advisory services of one form or another. In some areas of the business world, particularly that of companies not in the "big business" category, the utilization of accountants for such services is already extensive though far from its full potential.

Accountants' reports have, for many years, been utilized as aids in securing capital and credit, and as periodic guides to management in the analysis of their operations, efficiency, and profitability. In addition, accountants have increasingly acted as consultants and advisors to many of their clients, in varying extents, on all sorts of management problems and in most every phase of their business.

Thus, the approach to this subject is not one of novelty but rather that of the advocacy of a more conscious effort by the accountant to supply these advisory services to all of his clients and in all respects that come within the realm of the needs of his clients and of his qualifications; also, that he offer these services as a regular part of his practice and that he organize and equip himself as necessary for the independent furnishing of these services.

On the other hand, the conditions that place restraints on accountants in offering such services require equal consideration so that false hopes are not engendered and the development of the management services practice will be planned and carried out soundly and professionally.

The Need for the Accountant's Services

It need hardly be pointed out that businessmen are faced with constantly changing and increasingly complex problems in the conduct of their business. Except for the very large companies that have enough expert vice-presidents to deal with every phase of their company's operations, businesses must supplement their own limited management organizations with outside aids. These aids are independent management engineering organizations and accounting firms.

Competition is so keen that there is a very high premium on managerial competence. Managements must have both data and advice with respect to costs and expenses, trends, variances

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from standards, financial position, and many other subjects. Planning a business move requires information as to the tax consequences as well as a projection of the outcome. Coping with the higher wages and employee benefit costs, which develop almost annually, creates the need for compensating economies, or for probing the possibilities and the amount of needed price increases, or checking the ability to absorb the higher costs. Other areas for service, well known to accountants, are too numerous to list.

In this period of high, rigid overhead costs and inadequate profit margins, profit leaks cannot be tolerated for long without fatal consequences. Daily development of new methods, better machines, substitute materials and products, new promotion "gimmicks," higher distribution costs—all these and other problems force the smaller businessman to seek and depend on supplementary business advisors.

Helping business keep on the profitable side is a boon to the whole business community. Bankers and other credit grantors have come to recognize the unique role of the accountant, and credit is extended more freely where there is confidence in management and the accountants.

Lastly, the accountant also can play a role in our American society. It is well recognized that the existence of a democratic, free enterprise system is dependent on the maintenance of a large body of small and medium sized businesses. To the extent that accountants can help preserve their existence, they are providing a valuable public service.

The Accountant's Natural Advantages

In many areas of management advisory services the accountant enjoys a natural advantage over other independent advisors. Nevertheless there are too many instances where the accountant has been by-passed in management engagements either because he ignored a problem or made no effort to inform his client of it, or he did not have the experience to deal with it.

The ability to render technical and advisory services competently depends on the aptitude of the accountant for such work, his specialized education and training, the diversity and extent of his general experience, the intensity of his feeling for efficiency and organization, and a sound business instinct. It is not expected that accountants should try to become experts in every aspect of management. Many business situations do not require experts any more than every illness requires a medical specialist.

It is important that the accountant be able to recognize existing problems or future needs and inform management of them. Those that he can properly deal with should become special engagements for him. As to the others, he should recommend the engagement of competent independent specialists and, where practical, collaborate with them.

The frequent contacts that most accountants have with their clients give them an enormous advantage over strangers in dealing with a large number of common management problems. This advantage should be recognized by both the accountant and his client. Much time, at considerable cost, must be expended by an independent management counselor to "learn the ropes" of a business and get to know the personalities that constitute it. Ordinarily an accountant has accumulated this knowledge and knows the strengths and weaknesses of the principals and key men, and the bottlenecks and vulnerabilities of a company.

The diversity of an accountant's experience, or his specialization, have pro-

vided a broad base of observation. He has dealt with well-managed companies and observed "what made them tick." He has watched companies slide into bankruptcy and recognized their failings. To an alert, competent person, possessing an accountant's training and experience, these observations provide a most important base from which to supply advice to managements.

An accountant can conveniently follow up his recommendations and the working out of his installations because he usually is located close to the client or because of interim accounting functions. Some of the follow-up observations can be made in connection with audits. This benefit to the client is not a small matter, either in terms of accomplishment or in cost savings.

Common Areas of Service

Here are a dozen broad fields of management services that accountants are, in varying degrees, qualified to furnish. These alone, it should be observed, constitute an enormous opportunity for constructive service to clients as well as a source of gratifying, profitable engagements for accountants.

1. Accounting and clerical systems for office, factory, distribution, etc.—installation and modernization. (Includes accounting machines.)

2. Survey and improvement of internal control.

3. Cost systems for production, distribution, service, etc.—installation and modernization.

4. Development of cost estimating methods, where formal cost systems are not employed.

5. Establishment of formulae for the determination of selling prices and service rates.

6. Budgets—installation and modernization.

7. Internal reports—recommendations as to reports to be prepared for management by company employees and development of forms.

8. Analysis of operating statements and review thereof with management to bring out deficiencies and trends. Creation of efficiency standards and guides to profitability of products, branches, departments, personnel, territories, etc.

9. Analysis of financial position statements and counsel as to measures for short- and long-term financing, correction of inadequate turnover of receivables and inventories, etc.

10. Investigations and tax planning preliminary to business transactions such as absorptions, mergers, expansion of physical facilities and business operations, capital investments, etc.

11. Personnel relations matters—profit-sharing and pension plans, key-man compensation, labor union negotiations, incentive plans, etc.

12. Measures relating to perpetuation of the business—training understudies, shifting control, estate planning for business owners, insurance, etc.

All of the foregoing services have their roots in accounting and tax knowledge and in a broad understanding of the principles of sound business management.[1]

The results of a survey by the AICPA Research Department of the type of services actually supplied by a representative cross-section of the profession, have recently been publicized and should also be of interest.[2]

Other Areas of Management Services

There are other types of service that a relatively small number of accounting firms are qualified to provide because of the inclusion of non-accounting specialists in their organizations, either in

the partnership or staff ranks. Some accountants have unusual backgrounds of schooling and experience, or have developed specialized business and industry knowledge which equip them for uncommon services. A small number of firms (though large in size) have substantial industrial engineering or management advisory service departments (various titles are used) which provide many types of non-accounting base services.

In October 1956 the Committee on Management Services by CPAs of the American Institute of CPAs issued, for consideration by the Institute membership, a pamphlet entitled "A Classification of Management Services by CPAs." Therein are listed a large number of services that, presumably, can and are being provided by accountants. Some of them, however, have no roots whatsoever in the field of accounting services, for example:

PRODUCTION
- Investigation of new plant location
- Advice on types of equipment
- Survey and evaluation of production methods
- Survey of warehouse layout and space utilization
- Survey of material handling

SALES
- Development of market potentials and quotas
- Advice as to packaging methods
- Analysis of markets
- Study of advertising methods

SAFETY AND HEALTH PROGRAMS

The issuance of the pamphlet is an important act of recognition of the fact that management services no longer are a casual matter for accountants. Its objectives are meritorious and should be a boon to business as well as the accounting profession. However, in one respect this writer is strongly critical, namely insofar as the very rare and occasional services, such as "safety and health programs" or "advice as to packaging methods" are mingled, without any distinction, with services such as "development of cost accounting methods and procedures" and "designing and assisting in the installation of the general accounting system."

It is this writer's personal view that, though the pamphlet contains cautionary comments, the inclusion of the unusual and rare services is disparaging to the large body of accounting practitioners who do not, and probably never will in the foreseeable future, provide such services. This writer has been an early advocate[3] of the expansion of accounting services and believes that accountants may perform any services that are not in violation of the Institute and State Society codes of professional ethics and which they are competent to perform. However, publicity should be given only to the large, broad areas of service that the bulk of the practitioners can reasonably provide. The rare and unusual ones may be mentioned, as a group, by a reference to the fact that some firms are equipped to provide other more technical, specialized management engineering services. We must be mindful of the fact that copies of these pamphlets will ultimately circulate amongst businessmen, bankers, and others.[4]

An interesting and thought-provoking criticism of the pamphlet was expressed in an article by Professor Charles Lawrence which appeared in the October 1957 issue of THE NEW YORK CERTIFIED PUBLIC ACCOUNTANT.[5]

Organizing for Management Services

Extension of management services from a casual operation to an organized activity requires certain preliminary action. The amount and kind of prepara-

tion will obviously vary with the present status of the practitioner—namely, the size and composition of the firm and the number, size, and type of its clients. A program of preparation is here presented to cover the average needs. Adaptations can be made to suit the individual desires and requirements.

1. A survey should be made as to the most urgent needs of the clientele, and those which the accounting firm can most readily and effectively meet. The majority of practitioners will probably find that four service requirements may be dominant, namely:

(a) Improvement of accounting systems and the reduction of paper work.

(b) Cost determinations — integrated cost system installations or other methods for cost estimating.

(c) Operating and financial budgets and forecasts.

(d) Assistance in short- and long-range financing plans.

Whatever the dominant services in any instance, it is these to which the accountant should cater at the outset. Inexorably, the scope will enlarge as the practitioner deals increasingly with such services. An article by Joseph L. Brock, CPA,[6] deals effectively with this preparatory phase.

2. Partners should inventory their skills, aptitudes, specialized training and experience, and their special interests. For example, some accountants may have engineering degrees; some may have taken courses in specialized subjects. Other accountants may have intensive cost system installation experience; others may have had broad budget experience in industry before entering public accounting. One accountant may be very much interested in, and ingenious with, general system installations and have a good knowledge of punch-card equipment. Another accountant may have a natural instinct for business promotion and can be helpful in analyzing and discussing problems that confront executives in the consideration of such matters. These abilities and experiences can be pooled to be used when and where needed.

Some staff members may also have had specialized training and experience and they can be added to the talent pool. Partners and staff members can take specialized courses in such subjects as will be useful in their work and plans. There are relatively short courses offered in industrial engineering systems, costs, budgets, management principles, and other pertinent subjects.

A program of planned reading of books on management subjects will speed up the process of becoming familiar with any aspect of management. Subscriptions to trade magazines and to the releases by organizations such as the Society for the Advancement of Management or of the American Management Association will make available a wealth of reference material. Membership in the National Association of Accountants and reading of its NAA Bulletin are virtually mandatory. Pamphlets issued by the Federal Small Business Administration are also very helpful.

Office machinery manufacturers and printers of forms are continuously engaged in research and development and they supply their experience and knowledge free, and lavishly, in circulars and pamphlets. Their salesmen and system experts are available for consultation and cooperation. Accountants should get on the mailing lists of companies such as Remington Rand, Burroughs, Hadley, Underwood, International Business Machines, and other outstanding companies too numerous to list. Their catalogues and pamphlets should be kept in files by industry or subject, together

with the other related material that may be needed for reference.

As accountants have the occasion to work with specialists they should acquire knowledge and experience thereby. Even as they observe their clients at work, in the plant, sales room, or the office, they should be attentive to the mechanics of their operations. What better school can there be than the well-managed, successful business which the accountant can continuously observe from a most beneficial vantage point?

Discussions amongst partners and staff used in management work, at reasonably frequent intervals, as to noteworthy experiences and achievements can be very helpful. The references to new ideas picked up by each are a quick way to spread valuable information amongst those concerned.

If practical, a staff man, who has had good experience in the field of cost and system work, should be employed as a nucleus of a special service department, with all of his time to be devoted, if needed, to the special service engagements. If he happens to be an accountant, he can be helpful on accounting work in his spare time.

Obtaining and Handling Engagements

In their capacity as analysts of operating statements and balance sheets, accountants come into contact, directly or indirectly, with virtually every phase of management. To illustrate, assume that a client manufacturing company has suffered a decline in gross profit margin and solicits the accountant's aid in determining the causes. Countless factors might be involved in such a survey and any number of them could be found to be contributory. These are some of the questions that could be raised in such an investigation:

1. Is the cost increase due to a decline in unit production not adequately overcome by a decrease in overhead?

2. Did component costs increase without corresponding sales price adjustments?

3. Has there been any deterioration in machine or labor efficiency?

4. Are there any leaks in the receiving or shipping of merchandise, leading to unrecognized higher cost of goods sold?

5. Has there been a sharp increase in spoilage of materials?

6. Has there been an accidental increase in the formula use of raw materials per unit produced?

7. Is there any large scale pilferage by employees or others?

Etc., etc.

Each question leads into some different phase of management. To illustrate, question (2) would require an inquiry into the fluctuation in raw material costs and related sales price increases. Question (3), in part, concerns matters such as the "up-to-dateness" of the equipment and processes, machinery breakdowns and maintenance, efficiency of operators, soundness of production planning, etc., whereas, as to labor efficiency, there are problems of personnel relations, working conditions, soundness of compensation methods, training program, methods of engineering, and numerous other matters.

Turning to the balance sheet one may observe that accounts receivable are too high in relation to the usual terms of sale and the sales volume. What is wrong? It might be any one or more of these circumstances, each one of which involves some phase of management:

1. The credit department may be deficient.

2. Collection efforts are inadequate.

3. A poor class of customers is involved.

4. Sales invoices may not be sent out promptly.

5. Someone may be holding out customers' payments.

6. There are excessive controversies with customers due to differences as to quality, price, or delivery date; resulting in delays in payments.

Etc., etc.

Inasmuch as the profession's codes of ethical conduct prohibit advertising and solicitation, the practitioner is limited to his own clientele as the area in which he will function. This, at the very outset, influences the scale of his organization and the scope of his services. How would one go about advising his clients about the additional services he has to offer? The simplest form is by word of mouth. There surely must be numerous occasions when an accountant can, with propriety, point out a need for cost or budget work, or a survey to reduce paper work, or to tighten up internal control. He then also could point out that his organization can supply the service and then undertake to work out a special engagement therefor. A partner's mention of some outstanding achievements of his management department, in a casual conversation with a client, will very likely stir up interest on the part of the listener in helpful services for his own company. The term "department" need not be taken literally; it often is a convenient term of reference.

It is strongly urged that a management service engagement be undertaken only with adequate understanding of what is required and honest appraisal of the ability to carry it out competently, economically, and in a reasonable period of time. There should be no reluctance to call in, when necessary, independent specialists for collaboration. An engagement poorly carried out may not only result in loss of the fee but also in a loss of an accounting client.

The engagement should, whenever practical, be carried out independently of the accounting services. It should be followed up by a report and a review of such report with the client. Some firms have a different type of stationery for their management departments, to give the department an aspect of independence from the accounting department.

When new accounting clients are obtained it would be very advisable to arrange for a "management survey" at an early opportunity. Such a survey may disclose surprising conditions and result in a quick creation of confidence, goodwill, and a more liberal reaction to the initial fee proposals.

Fee Arrangements

In general, fees for management services should be on a level consistent with the importance of the services, the expected achievements, and the calibre of personnel involved. The per diem scale should be no lower than for accounting personnel of comparable rank, and a higher scale is usually justifiable on the grounds of the special nature of the engagement and the unusual talents and experience required.

Management advisory services may be classified into two major categories: first, the special, one-time engagements, and second, the year-long continuous consultation services. The first is billed upon completion or, if extensive, on an interim basis; the second may or may not be billed, dependent on the accountant-client relationship.

With respect to the special engagement service, a per diem rate basis is the most common and convenient one employed. It eliminates the speculative element as to time but unfortunately does not provide for accomplishment. However, it is the uncertainty as to accomplishment that is a major factor in the procrastination of clients in deciding on special services and in the deter-

mination of the fee basis. If the accomplishment difficulty cannot be overcome by the accountant on the basis of confidence or by convincing evidence then the following approaches may be effective:

1. An agreement on a ceiling price for the services either at a fixed amount, or, better yet, a maximum fee range, that is, a minimum and maximum between which the fee would fall.

2. Inasmuch as such a fixed fee arrangement may not constitute adequate compensation for anticipated extraordinary accomplishment, the practitioner might attempt to include in the fee agreement a provision to the effect that, in the event of better than anticipated results, the client will agree to discuss an upward adjustment of the fee. The adjustment may involve placing the fee on a full per diem basis, if that will serve the purpose, or a lump sum determined by mutual agreement after a review of the record. It may be assumed that if the client has obtained substantial satisfaction he will probably be amenable to a rectification of the inadequacy of the fixed fee.

3. If the client can be so persuaded, the fee settlement can be left to a time after the engagement has been completed. Then the two parties may review the time record and results and a fair fee agreed upon. This arrangement may prove to be most equitable in many cases because if the results are poor the fee will be low, but if the results are very satisfactory a better than average fee will result.

4. Even a per diem basis fee arrangement may have an achievement reward clause if the fixed per diem rates are lower than the initially proposed scale.

As to the second group of services, the casual year-long consultation services that are provided in the form of conferences and telephone discussions, the matter of fee is tied up with a number of obvious facets of the accountant-client relationship. Where such services consume considerable principal time, year after year, compensation therefor is obviously warranted. In such instances, too, achievement of an extraordinary nature should not go unrewarded. A fee arrangement for this type of service might properly be an annual retainer, the amount of which is to be reconsidered in the event of extraordinary circumstances. A fee for such services should not, preferably, be merged with a fee for auditing services. Thereby the advisory services are given the importance and separate compensation that they deserve. As a practical matter, however, expediency may dictate in some cases the inclusion of the casual management conference services in the annual accounting retainer, but with clear-cut recognition thereof.

The Limitations

The enthusiasm engendered by the recognition of the potentialities of the field of management advisory services must be tempered by the realization that there are several inherent limitations, to wit: (1) professional limitations and (2) practical limitations.

Professional Limitations

The ethical codes of the American Institute of CPAs and of the New York State and perhaps many other State CPA societies, as well as state laws, impose restraints, directly or indirectly, on the operation and development of the management department through provisions relating to the following:

Solicitation
Advertising
Use of CPA's name

Division of fees and profit with laity
Incompatible occupations
Contingent fees
Competitive bidding
Forecasts

In addition, questions have been raised as to the likelihood of conflict with concepts of independence, client confidences, competence, and the departure from the traditional province of public accounting, all of which are deserving of thought.

There appears to be a general concurrence that the professional rules of conduct apply to non-accounting activities undertaken by a CPA within an accounting firm, and even to those outside of an accounting firm if the latter activities are of a type commonly supplied by CPAs. The term "commonly" does not mean "performed by many accountants" but refers rather to a service that is not unusual for accountants.

There are certain activities that are engaged in by non-accountant management engineers that are prohibited to CPAs or as to which they do not have as much flexibility, to wit:

1. *Use of a corporation for management services.* A firm of CPAs may not use a corporation to furnish services that are commonly supplied by CPAs. They may not be officers, directors, stockholders, representatives or agents of a corporation supplying accounting services — and management services commonly provided by accountants constitute public accounting services.

2. *Management firm partnerships of CPAs and non-accountants.* If such a partnership violated the rules of professional conduct, the CPA members would be in violation unless they could demonstrate that the firm's services were not commonly supplied by CPAs, which is not likely in a broadly constituted firm. If this contention could be supported, the CPAs might run afoul of the "incompatible occupation" provision on the ground that the management partnership might be used as a feeder for the accountant partnership. The same position would hold if the management entity were incorporated.

3. *Non-CPA partners in accounting firms.* If a non-accounting specialist were made a partner in an accounting firm, to supervise management services, what might be the professional code involvements? No definitive answer is presently possible. Assuming that an actual situation exists, these are the possibilities:

(a) If the non-accountant were not a member of a recognized profession, it is likely that the sharing of profits with him would be a violation of the "non-sharing with laity" rule.

(b) If the non-accountant were a member of a recognized profession, say a civil engineer, it is less certain that the non-laity rule applies but it conceivably would be held applicable.

Partnerships with other professionals apparently are not specifically barred but there is a move underway to bring this about. State laws would also bear on this arrangement since most states have rules prohibiting the practice of public accounting by a partnership including a non-accountant partner; moreover, the firm could not use the title Certified Public Accountants in any state.

4. *Employment of experts as members of staff.* There presently appears to be no prohibition against the employment of non-accountants as members of a CPA firm staff to furnish services that are proper for an accounting firm. However, there appears to be a strong sentiment in support of the contention that

no firm should render a service through a staff man that a partner is not qualified to supervise. Thomas G. Higgins, CPA, remarked as follows on this important point.

> While there is a wide area of disagreement as to what work can be properly performed by a practicing CPA, particularly in the area of management services, it seems clear that an accounting firm should not offer to render services which could not be supervised or evaluated by at least one partner.[7]

A similar contention was made by Ira N. Frisbee, CPA, writing on the ethical problems of management services.[8]

5. *Advertising and solicitation.* These two promotional avenues are closed to CPAs, thereby limiting their management services to their own clients and referrals. Thus, the management organization should, as a practical matter, be consistent with the size, nature, and number of clients and their foreseeable needs.

Practical Limitations

The practical limitations are those imposed by the following factors:

1. Composition of the accounting firm—number of partners and staff, and their backgrounds.

2. Willingness of the firm to expand its operations into new fields.

3. Composition of the clientele—size, nature and number of clients.

Some practitioners have expressed their dismay at the idea of the profession deliberately enlarging its scope to include management services. They feel that the profession is already plagued with too many problems to voluntarily add new ones. Management and manpower problems might be "the straw to break the camel's back." Accounting schools, they also assert, do not train management personnel. These attitudes may have a defeatist or pessimistic air, but they may also be very realistic. Practitioners are therefore urged not to start "whooping it up" until they have soberly reflected on what they are undertaking.

Nevertheless, it is unlikely that the trend can be arrested; the need for the services exists and it must be satisfied. Those who can meet the challenge will move forward; those who do not or cannot will stand still or fall behind.

The experience of one accounting firm is cited to illustrate what may be encountered. Its clientele was essentially in manufacturing enterprises. A management staff of three was employed largely on cost-system and expense-control services. In time, the force had to be contracted, one man at a time, as the need for their services diminished until all three were gone. Apparently the clients' initial problems had been cleaned up and the continuing services could be handled by the regular accounting staff. Other such situations undoubtedly have developed and will continue to arise. This points up the fact that the facilities contracted for by CPAs for management services should have a flexibility that will not leave a firm with expensive space or a half-busy staff and little extra income.

Conclusion

The opportunities for constructive and rewarding service to clients in the field of management are considerable and challenging to the profession, despite the assumed and imposed limitations. The development of these services, strangely, may increase the employment of existing management specialist organizations because accountants will increasingly stimulate their utilization by clients. Our relations with other professions and specialized groups will develop a greater intimacy as collabora-

tion and cooperation are increased. These groups, in turn, should advance the cause of the accounting practitioner as they, in their independent activities, recognize the need therefor.

Management services are adjunct services which evidence increasingly greater dimensions and may possibly reach the importance, in time, for many practitioners, of the areas of service opened up by the federal income tax law. The traditional accounting services will, however, for a long time, constitute the bulk of the local practitioners' services and there must be no unwitting relaxation in our devotion to them. They are the foundation pillars of our practice.

References

1. A list of individual services that come within the management scope, also stemming from accounting, tax, and business management principles, will be found in *The New York Certified Public Accountant*, September 1955, p. 543.

2. "A Survey — Management Services by CPAs," the AICPA Research Department, *The Journal of Accountancy*, June 1957.

3. Max Block, "Cooperation with Clients and Credit Grantors in Wartime and Post-War Periods," *The New York Certified Public Accountant*, May 1945; also "Extension of the Certified Public Accountant's Position as an Adjunct of Business Management," *The New York Certified Public Accountant*, April 1946.

4. After this article was submitted for publication, the AICPA Committee on Management Services published a second report on management services by CPAs. The latter report avoids the criticisms levelled at the first one by excluding the controversial services. Strangely, the second report makes no reference to the first one, thereby leaving unmodified the unwarranted assumptions contained therein. It would be in order for the Committee to expressly indicate that the first report has been superseded.

5. Charles Lawrence, "Management Services and the Accounting Profession," *The New York Certified Public Accountant*, October 1957.

6. Joseph L. Brock, "Management Services by Local Practitioners," *The New York Certified Public Accountant*, September 1955.

7. Thomas G. Higgins, "Division of Fees," *The Journal of Accountancy*, January 1957.

8. Ira N. Frisbee, "Ethical Considerations in Rendering Management Services," *The Journal of Accountancy*, March 1957.

On Timely Reading of Professional Periodicals

It was during the dilemma of preparing this message for you, naturally caused by insufficient time, that I happened to withdraw from it all and settle down to look at the November 1957 issue of the *Journal of Accountancy*. Therein appears an article entitled "Statistics of the Profession" by James E. Hammond, a former Vice President of the American Institute of Certified Public Accountants. It is an article that certainly should be of great interest, and in some respects of great concern, to every active practitioner, particularly the small firm practitioner.

Since I am told too, in the same issue, that the *Journal of Accountancy* is read, on the average, from three to eight weeks after receipt, it would seem a service to you to point out the foregoing article for your immediate perusal.

It occurs to me that a similar lapse of time might be involved in the reading of *The New York Certified Public Accountant*. I would like to urge all of our Chapter members to review and read these two publications as soon after receipt as possible. They are our two most valuable professional periodicals. A practitioner cannot afford to be remiss in the timely reading of them. We must keep our professional inspirations alive, and there is nothing better to hone these on than professional papers prepared by members of our profession.

Robert S. McLellan, *"President's Message," Nassau Suffolk News, December 1957*

New York State Tax Forum

Conducted by BENJAMIN HARROW, C.P.A.

Real Estate Corporation—Change of Classification . . . Personal Income Tax—Definition of Dividends . . . Insurance Brokers—Status Under Unincorporated Business Tax.

Real Estate Corporation—Change of Classification

We have frequently called attention to the fact that the classification of a real estate corporation will be changed to that of a business corporation if the property of the real estate corporation is used by a business corporation that controls the real estate corporation. This is provided for in Section 211.4 of Article 9A.

But Section 182 of Article 9 provides that any corporation classified as a real estate corporation, which becomes taxable as a business corporation, must pay an additional tax of 2 per cent on the amount of its surplus at the time of such change of classification. The Commission takes the position that surplus subject to the additional tax includes earned surplus and surplus resulting from appreciated values.

Suppose the book value of real estate is $100,000 and the assessed value $125,000. Upon a change in classification the appreciation of $25,000 in assessed value over the book value will be considered part of the surplus subject to the 2 per cent tax. Suppose the property is later sold for $150,000. Is the corporation subject to a capital gain of $25,000 or $50,000? In our opinion, the basis for determining gain remains $100,000, the book value. There does not appear to be any authority in the law for stepping up the basis of the property to the corporation, merely because it has been subjected to a 2 per cent tax on a surplus that included an appreciation in the value of the property.

If the property actually had been distributed to the stockholders, in a liquidation for example, the latter would take the property at least at the assessed value, and as to them the basis would be stepped up and of course the corporation would be subject to the 2 per cent tax on any appreciation over book value.

Personal Income Tax—Definition of Dividends

The attorney general was recently requested to reconsider an earlier opinion (1953 atty. gen. 189) which held that distributions to stockholders of surplus resulting from appreciation in value of

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corporate assets were dividends taxable as ordinary income. Specifically, the attorney general was asked to reconsider his earlier opinion in the light of *Commissioner* v. *Gross** which held that such a distribution was a return of capital and subject to tax as a capital gain, and not as ordinary income.

The attorney general confirms his earlier opinion and holds that the construction by a federal court that such a distribution was a capital gain under federal law does not control with respect to the state law. The attorney general is of the opinion that the definition of *dividend* in the Tax Law (Section 350(81)) includes a distribution made from a surplus resulting from an appreciation in value of corporate assets.

The statute defines *dividend* as any distribution by a corporation *out of its earnings or profits.* Says the attorney general, an appreciation in the value of capital assets of a corporation is an "earning" or "profit" on the basis of which a dividend may be paid. He goes on to say that the *Gross* case is readily distinguishable considering differences between the language of the federal law and the state law.

In our opinion the attorney general is in error. He is broadening the definition of income to include income in the economic sense. But taxable income is narrower than that. Taxable income must be the result of a completed transaction, generally a sale or exchange of property. Taxpayers affected by the ruling will probably seek an adjudication of this issue in the courts.

Insurance Brokers—Status Under Unincorporated Business Tax

One of our members asks, "Would you advise insurance brokers to commence an action to be exempt from unincorporated business tax?"

We assume that our member seeks the exemption on the ground that the broker is an employee receiving a commission or salary for his services and not an independent agent. The commission considers them independent agents probably because they are so held under the Social Security Act. An ordinary salesman employed on a salary or commission basis, with or without a drawing account, is not an independent agent subject to the unincorporated business tax.

We would not advise insurance brokers to seek exemption from the unincorporated business tax on the ground that they are employees. What about exemption on the ground that they are engaged in a profession in which more than 80 per cent of gross income is derived from personal services and in which capital is not a material income-producing factor.

The Tax Commission has defined a profession as including "any occupation or vocation in which a professed knowledge of some department of science or learning is used by its practical application to the affairs of others, either advising, guiding, or teaching them, and in serving their interests or welfare in the practice of an art founded on it." The word implies attainments in professional knowledge, as distinguished from mere skill, and the application of such knowledge to uses for others as a vocation.

Exemption under this section has been a much litigated one. In fact the court has held** that persons operating a general agency for a life insurance company were not engaged in an exempt profession. The Tax Commission associates the term profession with knowledge acquired in a school of learning, preferably leading to a degree.

* 236 F. (2d) 612; CA 2, 1956.

** *Recht & Kutcher* v. *Graves* (1939), 257 App. Div. 889.

Accounting at the SEC

Conducted by Louis H. Rappaport, C.P.A.

Accountants' Certificates in Initial Examinations

In last month's issue of this magazine we discussed briefly the question of opening inventories in examinations which represent an accountant's first contact with the client. In such cases accountants ordinarily will not have observed the taking of opening inventories and consequently may be faced with a problem in certifying the income statement. As we stated last month the question is particularly pertinent in SEC practice because a public offering of securities is frequently the reason for engaging an independent accountant to examine and report upon the financial statements of a company.

It may be interesting and informative to examine a few typical certificates issued by accountants faced with the situation we have been considering.

The examples which appear below were taken from prospectuses actually filed with the SEC but all names have been omitted. These examples are furnished not as recommendations but as illustrations of how the problem has been dealt with by some accountants. From the fact that these certificates appear in final offering prospectuses, it may be assumed that they were acceptable to the staff of the SEC.

Louis H. Rappaport, C.P.A., *a partner in the firm of Lybrand, Ross Bros. & Montgomery, C.P.A.s, is the author of* SEC Accounting Practice and Procedure.

EXAMPLE 1

We have examined, etc., as at August 10, 1957, and the related consolidated statements of profit and loss and earned surplus for the three fiscal years 1954, 1955 and 1956 and for the thirty-two weeks ended August 10, 1957. Except as described in the following paragraph, our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

We had not made examinations prior to August 10, 1957 and were therefore unable to follow generally accepted auditing standards with respect to the inventories at dates prior to August 10, 1957 which were used in determining cost of goods sold for the three years and thirty-two weeks ended August 10, 1957. However, our examination disclosed no information which would lead us to believe that those inventories and the cost of goods sold are not fairly stated.

In our opinion, the accompanying balance sheet presents fairly the financial position of (Company) at August 10, 1957 and, with the explanation in the preceding paragraph as to the limitations on inventory examinations, the results of operations for the three fiscal years and the thirty-two weeks then ended, in conformity with generally accepted ac-

counting principles applied on a consistent basis.

EXAMPLE 2

We have examined the Consolidated Statement of Assets and Liabilities of (Company) at December 31, 1951 to be transferred on December 31, 1952 as then existing as listed in the accompanying index and the Statement of Profit and Loss for the three years ended December 31, 1951. Our examinations were made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances. Physical inventories, taken annually by the Company during the fifteen years we have been auditing the accounts, have been subjected to all auditing procedures except that of test-checking quantities which was omitted by agreement because the stock of the corporation has been closely held. Based upon such examination we have no reason to believe that the inventories reflected in the statements are other than fairly stated. We have previously made annual examinations, similar in scope, of the consolidated financial statements of (Company) for the two years ended December 31, 1948 and have reviewed the summary of earnings included in the Prospectus for the five years ended December 31, 1951.

In our opinion, with the qualification implicit in the foregoing paragraph, (1) the accompanying Consolidated Statement of Assets and Liabilities of (Company) at December 31, 1951 to be transferred on December 31, 1952 as then existing and the Statement of Profit and Loss present fairly the consolidated position of such net assets and the results of its consolidated operations for the three years ended December 31, 1951 and (2) the summary of earnings presents fairly the net operating consolidated profit or loss from operations before taxes for the five years ended December 31, 1951, in conformity with generally accepted accounting principles applied on a consistent basis.

EXAMPLE 3

We have examined, etc., as of May 4, 1957 and the related statement of consolidated earnings and retained earnings for the three years and eighteen weeks then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

We were not engaged as auditors of the company until Mareh 1957 and therefore it was not possible for us to observe physical inventories taken with respect to the year ended December 29, 1956 and prior. Moreover, records were not available with respect to physical inventories taken for years prior to and including the year ended December 31, 1954. The inventories not observed by us were tested against available inventory records and other operating data and although there may be variations which would affect the reporting of income or loss between the various years, nothing came to our attention which would indicate that the inventories are not fairly stated.

In our opinion, with the foregoing explanation as to the limitations on inventory examinations, the accompanying balance sheet and related statement of consolidated earnings and retained earnings, in so far as it relates to the three years and eighteen weeks ended May 4, 1957 present fairly the financial position of (company) at May 4, 1957 and the results of operations for the periods stated, all in conformity with generally

accepted accounting principles applied on a basis consistent in all material respects.

EXAMPLE 4

We have examined the financial statements of (Corporation) as listed in the accompanying index. Except as indicated in the succeeding paragraph, our examination was made in accordance with generally accepted auditing standards, and included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

Since this is our initial examination of the financial statements of (Corporation), we were not in attendance to observe procedures followed in determining physical quantities recorded in the inventories for any year prior to 1954. Such inventories, however, are in agreement with (Corporation's) physical inventory sheets which we inspected and tested as to arithmetical accuracy and pricing. As stated in Note 2 to the financial statements, it has been the Company's consistent policy to include in its physical inventories only such material as is currently active, and to exclude from inventories any item in which there has been no movement during a period of six months prior to physical inventory taking. Based on auditing tests which we were able to apply, we have no reason to believe that any significant amounts of such inactive inventories excluded at December 31, 1954 and in prior years have been subsequently used in production or sold.

In our opinion, with the explanation in the preceding paragraph relative to inventories, the accompanying balance sheets and statements of earnings and earnings retained in the business present fairly in all material respects the financial position of (Corporation) at December 31, 1954 and the results of their operations, individually and combined, for the five years and three years, respectively, then ended, in conformity with generally accepted accounting principles applied on a consistent basis.

EXAMPLE 5

We have examined, etc., at December 31, 1954, the related summary of earnings for the five years then ended and the related statements of surplus for the three years then ended. Except as explained below, our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

We observed the taking of physical inventories as of December 31, 1951 and subsequent years but we did not do so with regard to the inventories at December 31, 1949 and 1950; however, our tests of the accounting records for 1950 and 1951 have given us no reason to believe that such inventories have not been fairly stated.

In our opinion, with the foregoing explanation as to inventories at December 31, 1949 and 1950, the above described statements present fairly, in conformity with generally accepted accounting principles applied on a consistent basis during the period (1) the financial position of (Company) at December 31, 1954, and (2) the results of operations for the five years ended December 31, 1954.

Administration of a CPA Practice

A forum for the exchange of views and information on all aspects of the administration of an accounting practice.

Conducted by Max Block, C.P.A.

Relaxation and Professional Progress

A proficient person is one who is well advanced in any business, art or science—in brief, an expert. The development of proficiency, Aldous Huxley tells us, is dependent on the combination of relaxation with activity. In his essay "The Education of an Amphibian" he makes this sage observation:

> In all the activities of life, from the most trivial to the most important, the secret of proficiency lies in an ability to combine two seemingly incompatible states—a state of maximum activity and a state of maximum relaxation. The fact that these incompatibles can actually coexist is due, of course, to the amphibious nature of the human being.

The need for relaxation is receiving increasing attention in well managed businesses, particularly with respect to the upper echelons of executives. So much is expected from this talented group, and for so long a time, that their wellbeing is a matter of official concern and the subject of official policy. The same attitude, obviously, should pervade the accounting profession. The opportunities for physical relaxation are not readily available to staff members, but, because of their youth, they have less need for it than their older employers.

What constitutes relaxation—is it occasional golf or fishing, or a two-weeks' vacation? Yes, these may be relaxing activities if indulgence does not create indigenous anxieties and frustrations. However, relaxation should not be sporadic; it should be intertwined with activity so that, by a wise combination of both, the best development of proficiency is possible. Spending the evening at home is not necessarily relaxing if one transfers to it his business problems or is otherwise unrelaxed.

How can the accounting principal relax during his working day? Here are several thoughts, practical and dreamy, but they may be of help to some.

First, some time should be devoted to complete detachment from the tasks of the day. For example, upon returning from lunch, spend fifteen or twenty minutes alone and undisturbed. Think of nothing in particular or of yourself in what some call the spiritual aspects.

Second, be comfortable physically. If your shirt collar is too tight, open it. If your belt is too tight, loosen it. If your suspenders are too short, lengthen them or slip them off your shoulders. If you must wear a jacket in the office,

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keep a very comfortable one around for that purpose. Do your bunions bother you?—keep a pair of slippers on hand for office use. Unconventional ideas these are for professional men, but how much better they will make you feel.

Third, make sure that the office in which you spend so much of your living day is as comfortable as possible and as conducive to relaxation as you can make it. Most offices are confining cubicles that breed claustrophobia. High rent may limit the size of your office but a certain kind of paint job or a mural on the opposite wall can create the illusion of greater height or depth. Really good lighting, scientifically installed, is essential. A scientifically proper chair for sitting, and one to lounge in, should be standard equipment. A couch for resting and for meditation will be found invaluable. A constant supply of fresh air and smoke-free conditions are helpful. Even the adequacy and arrangement of facilities to make work easier, to find things more easily, to dispose of matters more quickly, all play an important role in keeping a man more relaxed than he would otherwise be.

Other facets of relaxation, obviously, can be cited ad infinitum, but the rest will suggest themselves. Relaxation should not be looked upon as synonymous with laziness. It is a form of efficiency applied to a man's living while working.

The Need for Adaptability

For almost a quarter century our opinions on financial statements have been expressed in terms of a concept of general acceptability of a body of accounting principles as the criterion of fair presentation. This has had many important advantages which need not be now discussed but it introduced a serious obstacle to progress in accounting research. Basic rules or conventions of general applicability in accounting are founded on assumptions. If we are to avoid stagnation, we must be free to re-examine these assumptions in the light of current conditions.

New medical techniques and new drugs are critically analyzed and tested before they are offered to the general public. The law is fluid and shifts as opinions are handed down by the Courts and business accommodates itself to the changes. As a profession we are under the handicap of lacking a laboratory in which the new may be examined and tested against the old. We must, I think, reconsider our position and try to find a formula which will provide greater assurance of producing conclusions, the validity of which will command general acceptance not alone by professional accountants but by businessmen. We must try to find an approach which will permit sound experimentation and trial of new ideas and still afford protection against abuse.

Alvin R. Jennings, *"A Reappraisal of the Profession's Problems," an address delivered at the AICPA annual meeting, October 1947*

Payroll Tax Notes

Conducted by Samuel S. Ress

Reduction in Subsidiary Unemployment Insurance Tax Rate

The subsidiary unemployment insurance tax rate for 1958 will be one-tenth of one per cent of taxable payrolls. In 1957 the rate was three-tenths of one per cent, added on to the regularly computed "experience" rate of employers and represented a total additional cost to them of over $40 million. It is expected that the reduction in the subsidiary contribution will save employers in this State during the year 1958 approximately $39 million.

Under an amendment to section 577.4 of the Unemployment Insurance Law enacted last year relating to the *general account*, balances standing to the credit of individual employers who had gone out of business, were transferred to the *general account* from such former employers' individual accounts. In this way there became available to the *general account* a $42 million wind-fall credit which enabled the Industrial Commissioner to reduce the amount of the subsidiary contribution.

The 1958 unemployment insurance tax rates, after the addition of the one-tenth of one per cent subsidiary contribution rate, will range from .6 per cent to 2.8 per cent for experience-rated employers. Employers who first became subject to the law after June 30, 1956, will pay unemployment insurance contributions in 1958 at the 2.7 per cent rate.

A question arises as to the rights of an "out-of-business" employer whose credit balance has been transferred to the general account, in the event that he should start operating again. Will he have to build up a new credit balance in order to participate in experience rating or can he call upon the Industrial Commissioner to restore to his individual account such credit balance?

In 1957, 97,326 firms or 41.5 per cent of the covered employers in the State, did not qualify for experience rating because of insufficient experience, negative account balances or tax reporting delinquency. Most of these firms had not been in the system for at least four calendar quarters prior to July 1, 1956.

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Those firms were assigned a 2.7 per cent rate and were not subject to the subsidiary contribution assessment.

There were 32,000 firms which had failed to qualify for experience rating and had to pay unemployment insurance contributions at the top rate because they had negative account balances. The amount of benefits paid to their former employees exceeded the amount of taxes credited to their accounts, on the tax computation date which is June 30, 1957 for rates to be fixed for the calendar year 1958.

Under the provisions of the law such negative-account employers are ineligible for reduced rates for a period of three years. Consequently, any firm which had a negative balance in its individual account on June 30, 1957, will be assigned the maximum rate plus the subsidiary contribution rate on its taxable payrolls for the calendar years 1958, 1959, and 1960 regardless of how favorable its individual account balance may happen to be on the computation dates falling in each of those years.

The New York State Department of Labor has issued a tabulation of "Average Tax Rates For All Covered Firms And For Rated Firms By Detailed Industry Classification—1957, 1956 And 1955" which could serve as a guide to accountants in advising their clients as to whether or not the rate assigned to a particular account was out of line as compared with the general experience of competitors in the particular industry. A comparison might also indicate whether or not the assignment of a rate to a particular account should be questioned and whether there appears to be a need to institute tax controls not heretofore employed by the client.

The Language of Accountants

Accountants, in developing methods of financial statement presentation, have developed an effective technique that serves the purpose of compressing financial information of considerable variety and scope into an amazingly small package. It would be difficult to find any other kind of document where such a small number of words and figures can be made to yield so many meaningful disclosures in the hands of a sufficiently sophisticated reader, particularly if the reader has access to the financial statements in historical series over a number of successive years. . . .

The accountant is engaged in a constant struggle to achieve both brevity and clarity in his reporting. Unless his reports are brief, they cannot be clear; however, they may be too brief and, hence, unclear. If the accountant's reports are wordy, few people will bother to read them. Those who do persevere in wading through the mass of detail will lose the effect of any intended emphasis on salient features. On the other hand, it is fatal to achieve brevity at the expense either of clarity or accuracy. A report that is brilliantly misleading is plainly a worse offense against professional competence and probity than a report that is dull but harmless.

AN EDITORIAL, *The Canadian Chartered Accountant, October 1957*

Federal Income Tax Notes

Conducted by RICHARD S. HELSTEIN, C.P.A.

Holding Period of Property . . . Filing Form 7004 . . . Errors on Form 1065 . . . Losses On Prospective Business . . . "Substantially All" the Assets in Reorganization . . . Circulation Expenses.

Holding Period of Property

Where there is a complete liquidation of a corporation which distributes all of its property within one calendar month, Section 333, IRC 1954, provides for nonrecognition of gain to the shareholder-distributees upon the property transferred (except to the extent of the ratable share of earnings and profits and certain cash and securities distributed). Thus, where there is a large unrealized appreciation of an asset or assets of the corporation, they can be distributed in liquidation without recognition of the increase in value. Since the gain is unrealized, it would not be reflected in accumulated earnings and profits of the transferor-corporation.

However, the benefits of Section 333 are not available to a taxpayer which qualifies as a collapsible corporation under Section 341. One of the requirements which must be met for property of the corporation to constitute "Section 341" assets, and thus qualify the taxpayer as a "collapsible corporation," is that the property be held by the corporation for a period of *less* than three years (Section 341(b)(3)).

The last paragraph of Section 341(b)(3) provides that in determining the holding period of property, the basis of which is determined by reference to its basis in the hands of a prior owner, the holding period in the hands of the prior owner shall be tacked on to the period the property was held by the liquidating corporation, pursuant to Section 1223.

Thus, where a partnership in the real estate business transferred to a corporation its properties which it had held for more than three years, in a transaction which qualified under Section 351, and the corporation wished to liquidate after one year, Section 341 would not apply, because the properties had a holding period of more than three years. Since Section 341 is inapplicable, the shareholders of the corporation may elect to enjoy the benefits of Section 333. (Rev. Rul. 57-491, IRB-1957-43, 24.)

Filing Form 7004 Establishes New Corporation's Accounting Period

Where a new corporation, which is organized during the year, files Form 7004 (Application For Automatic Extension For Time To File U.S. Corpora-

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Mr. Helstein has contributed to accounting and other publications, and delivered addresses before our Society and other professional societies. He is associated with J. K. Lasser & Co.

tion Income Tax Return) based upon a period beginning with the date of its organization and ending December 31st, and further, pays its estimated tax based upon that period, it has in effect established a calendar-year accounting period. Accordingly, it must file its return based upon a year ended December 31 unless it obtains the approval of the Commissioner to change its accounting period, or unless the corporation meets the requirements of Regs. Section 1.442-1(c) or (d). (Rev. Rul. 57-589, IRB 1957-50, 9.)

It is not indicated in the above-cited ruling whether both actions are required to establish the accounting period or whether either action, if performed singly, would be sufficient to establish the accounting period.

Errors on Form 1065

The following Notice, which appears in IRB 1957-50, 55, is reproduced in its entirety:

> An examination of Form 1065 for 1957, U. S. Partnership Return of Income, discloses an error in a line reference and in Schedule N, as follows:
>
> (1) Line 11, page 1, should read: Gross profit (line 2 less line 10).
>
> (2) The amount to be entered on line 8, Schedule N, page 4 (Net earnings from self-employment) should be increased by any loss reported on line 31, page 1, or decreased by any gain reported thereon.

Losses On Prospective Business

Sec. 165(c)(2) IRC 1954 allows a deduction to individuals for losses incurred in any transaction entered into for profit, though not connected with a trade or business.

The question has arisen as to whether expenses incurred in the investigation of a trade, business or other transaction come within the purview of the above provision where the transaction was not carried out.

The Service, after considering various cases litigated under similar provisions in preceding laws, has ruled that such losses are deductible only where the transaction has actually been entered into, and the project then abandoned. Costs of investigatory activities which are carried no further are not covered. (Rev. Rul. 57-418, IRB 1957-38, 9.)

"Substantially All" the Assets in Reorganization

In determining whether "substantially all" the assets of a corporation in reorganization have been transferred in compliance with Sec. 368(a)(1)(C), the amount, nature and purpose of retention of the assets not transferred shall be determinative.

A corporation which transferred only 70 per cent of its assets, but used the retained assets to satisfy existing liabilities, and then liquidated, is held to have transferred "substantially all" its assets. Furthermore, the assets retained were not "operating assets."

In issuing this ruling, the Commissioner has withdrawn his non-acquiescence to *Milton Smith* (1936, 34 BTA 702) recorded at XV-2 CB 46 (1936). He distinguishes and reasserts I.T. 2373 (VI-2 CB 19, 1927) where operating assets of a business are not transferred and which may be used to continue the business at a future date, or which may be sold to another purchaser. (Rev. Rul. 57-518, IRB 1957-45, 14.)

Circulation Expenses

When a taxpayer elects to deduct circulation expenses under Sec. 173 IRC 1954, those expenses must be deducted in the year in which they were incurred even though the income may be deferred. Rev. Rul. 57-87 (IRB 1957-10, 19) covering this procedure is more fully discussed in NYCPA Vol. XXVII, No. 5, May, 1957, page 359. However, even though such expenditures are deducted currently for tax purposes, they may be treated as deferred expenses on the taxpayer's books and records. (Rev. Rul. 57-526, IRB 1957-45, 12.)

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